THE TAXATION OF WAR WEALTH

BY

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SECOND EDITION

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PREFACE TO SECOND EDITION

THE first edition of this book was published in March 1941, just before the Budget in which Sir Kingsley Wood announced his provision for the repayment after the war of a proportion of excess profits-tax liabilities. Since a proposal of this kind had been favourably commented upon by us, it seemed necessary, when preparing a second edition, to rearrange Chapters XI and XII so as to redress the balance between possibilities and actualities. We have taken the opportunity to comment further upon other amendments introduced into British excess profits taxation, and to elucidate a little our own suggestion for an excess income tax, combined with an excess profits tax at lower rates, the precise point of which was perhaps not made sufficiently clear in the first edition.

It is not possible, particularly in war-time, to bring a book like this generally up to date like a periodical work of reference. There has, since we wrote, been a capital levy in Finland; but we have declined the temptation of making an extra chapter out of the summary of its provisions which was all that was available to us. We have, on the other hand, made some amendments to the chapter on Nazi finance, since tendencies which we had already noted have become much clearer with the lapse of another year. And we have made some alterations to the chapter on the British Dominions, from some of which we received valuable criticisms of our first version.

April 1942.

PREFACE TO FIRST EDITION

THIS book was begun as the result of a grant made in January 1940 by the National Institute of Economic and Social Research, for the comparative study of Excess Profits Taxes and Capital Levies. Information was accordingly collected about the working of these taxes in various foreign and overseas countries; it is set out in Parts IV and VI below. But much still remained to be done before conclusions could be drawn from this information. An attempt had to be made to look at the problem against the background of war economics in general; British experience with excess profits taxes, and investigations into the possibility of a capital levy, had to be examined, and compared with experience abroad; only at this stage did it become possible to set out general principles which could be used as a basis for practical suggestions. We have attempted to make some suggestions about the probable future of the Excess Profits Tax at present in force in Great Britain, and about the possibilities of a Capital Levy or capital tax during or after the present war.

The field which is covered is thus a fairly wide one; but it is not the whole field of war taxation, nor even the most important part of that field. We have among our cases one example—that of Imperial Germany in the last war—of a country which did try to finance most of its war expenditure out of these rather fancy taxes; the consequences were utterly disastrous, both during the war and afterwards; as we shall see, they had to be disastrous. The greater part of the cost of war needs to be met out of taxes which fall in the ordinary way upon ordinary incomes; if this necessity is evaded, there is bound to be trouble. We have tried to keep the necessity for high ordinary taxation steadily in mind throughout, though the ordinary war taxes are not our particular subject. The striking unanimity of British economists in nearly all their utterances on this matter made it seem unnecessary to labour the point here.

There is another aspect of general war economics which we have had to go into in greater detail, since for obvious reasons it has been much less widely discussed up to the present. This is the financial problem of the end of war and of the aftermath, leading on to the question of the legacy of debt. It was impossible to discuss our particular taxes at all thoroughly without saying a good deal about

the after-war situation. Naturally the discussion has to be extremely tentative; but since there are certain financial problems which are bound to come up in any country which survives a great war, it can do no harm, and may do good, if we give them a preliminary airing.

The comparative economic study of the fiscal systems of different nations is one which has been rather neglected in England; it is rather an unfortunate omission. This is not because foreign tax systems show us much which is worthy of imitation; very few of them can challenge comparison, either on grounds of equity or of economic or administrative efficiency, with our own. Some of the best (such as the American) suffer from the defects which seem to be the inevitable consequences of a Federal form of government. One has not to go very far before one encounters systems which can only be described as rough and ready affairs, done on the cheap, with justice left out. But these things ought to be known. It ought to be appreciated how far the incredible weakness of many continental fiscal systems was responsible for the great inflations of the nineteen-twenties; it ought to be appreciated how far the great fiscal revolution carried out under the Weimar Republic has increased the economic strength of Hitler's Germany. Further, it is only when we see them against the practice of other countries that we begin to appreciate what a precious inheritance our own fiscal standards are; an inheritance which needs to be appreciated if it is to be developed, which needs to be developed (and constantly adapted to new conditions) if it is to be maintained. It is part of the substance of democracy and good government, while the loud-sounding principles are only a label on the box which may contain little or nothing.

Further examination of these interesting topics will have to await another occasion. In this work we are only concerned with fiscal systems operating under the strain of war, when all alike are at their worst. It is precisely when we are exposed to that strain that the temptation to fall below our traditional standards is at its most severe. A look in the faces of Giant Pope and Giant Pagan may perhaps help to keep Christian in the path of wisdom and justice.

It will, I hope, be understood that this book has had to be written in a great hurry if it was to be of any use; and not in the most favourable conditions. To write (one hopes objective) remarks about German finance with German planes droning overhead is a queer experience. While we have attempted to maintain the sort of

scientific standards which would be demanded from a book of this kind in peace-time it has not been possible to do so in all respects. We have had to rely upon secondary sources for a very large part of our information; indeed, if we had not been able to draw upon such valuable works as Dr. Haig's American report on the British E.P.D., Professor Einaudi on Italian Finance, and Dr. van Sickle on Direct Taxation in Austria, we should not have made much progress. We may at least claim to have used sources in a good many languages! When we began our work, we hoped to be able to check over some of this information by direct inquiries; but the field for that has got progressively narrower. A letter directed to Denmark in the first week of April came back through the dead letter office. Even over the British excess profits taxes it has not been possible to make inquiries on the scale we should have desired to do if there had been more time and opportunity; for the most part we have had to use the ordinary accounting text-books, and to consult with such expert opinion as was available in Manchester when we got into difficulties. Mr. C. H. Marsh, of Henry Simon Ltd., and Mr. A. P. Wilkinson of the Inland Revenue, have given us some particularly useful advice on these technical points. My colleagues, Mr. T. S. Ashton and Dr. H. W. Singer, have made valuable suggestions about certain chapters; Mrs. M. T. Hollond, of Girton College, Cambridge, has supplied us with some important figures; Dr. W. P. Morrell has given us some valuable hints on Dominion finance. To all these people we offer our thanks, as well as to the National Institute and its acting Director, Mr. Crowther, for their help and encouragement.

There has been a fairly clear division of work among the three authors, which is best set on record. I am mainly responsible for Parts I, II, and V; Mrs. Hicks for Parts III and VII; Dr. Rostas prepared most of the material for Parts IV and VI. Of course there has been a good deal of poaching, I hope to our mutual advantage. A first draft of Part III was given by Mrs. Hicks as a paper to the Manchester Statistical Society in March 1940; much of Chapter XXIII appeared as an article by Dr. Rostas in the *Review of Economic Studies* for October.

J. R. H.

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CHAPTER I

ECONOMIC INCENTIVE IN WAR-TIME

THE mobilization of labour and capital for national purposes, which has to take place in war-time, may be brought about in two different ways, either compulsorily or voluntarily. For recruiting the armed forces the method of compulsion or conscription has been mainly used by modern States; while in the forms of priority and rationing the same method has been widely extended to the equipment of the forces and to other incidental purposes of war. Obviously, in the twentieth century, the method of compulsion is gaining ground, but it has rarely gone far enough to be able to dispense with the other method altogether. The War Wealth, some of whose problems will be studied in this book, is a consequence of the other method, the voluntary method; clearly it is one of the most unwelcome and unpopular consequences. It is not at all surprising that modern wars should have been fertile of expedients for controlling it, and limiting it, and reducing it; these expedients we shall study at length. But before passing on to that study it would seem proper to begin by inquiring whether war wealth, as such, has any *raison d'être*. How we decide this question will make all the difference to our judgements on the measures which have been taken, or may be taken, to deal with it directly. Is the emergence of war wealth a necessary evil of war, or is it an evil which can be dispensed with by better organization without damaging the efficiency of the war effort?

No one would have anything to say against the voluntary method if the motives which led individual citizens to offer their labour and capital for public use were wholly altruistic. The appeal to patriotism by which Kitchener's armies were raised in 1914 and 1915 was based on motives of this nobler sort. There can be no finer way of recruitment than that; if it were sufficient it would be ideal for all purposes. Unfortunately it seems to be far easier for human beings to rise to the height of making some great decision

on altruistic grounds than it is to regulate the conduct of apparently pettier affairs on the same principles. Now the efficient conduct of war does require that a great many people should make countless small decisions in the right way; the munition worker has to put every ounce of his energy into his work, and to go on doing so; the merchant, the shopkeeper, and the consumer have to see that scarce supplies of goods are not frittered away on unessential purposes; the business-man has to sacrifice leisure and comfort, and also (what is sometimes even harder) to be prepared to take no thought of the morrow, and to sacrifice future advantages for his business to the overwhelming national needs of the present. If these things had to be done only occasionally, or for a short time, they might be done from pure patriotism; there are perhaps a few who can keep up this white heat for long periods. But it is asking too much of human nature to expect the ordinary man to go for a long time regulating all the details of his life in the light of public necessity; the voluntary principle has to be reinforced by some degree of economic incentive if it is to work at all smoothly in detailed application.

If the mobilization of resources for war is left to demand and supply, war wealth necessarily emerges; for the sorts of human qualities which are most intensely needed for war are altogether different from those which are most intensely needed in peacetime, and the sorts of property most intensely needed are also different. The use of the economic incentive necessarily implies a rise in the incomes of those people whose personal capacities or material possessions are most needed for war purposes, relatively to the incomes of other people; exceptional profits and exceptional wages begin to appear. They have to appear if we rely on the economic incentive; they cannot be avoided altogether by direct measures undertaken to repress them; they can only be avoided by organizing the war effort in some other way.

The only effective way of preventing war wealth from arising is to rely upon the compulsory method of mobilization rather than the voluntary method; if people are compelled to use their labour and capital for the purposes determined by the State, it is not necessary to pay them higher incomes in order to induce them to do so. This solution has in fact been adopted for the recruitment of the armed forces themselves, and it tends to spread over the rest of the field to some extent; but there are several reasons why

it is very difficult to extend it over the whole field. Let us see what those reasons are.

In the first place, some of the various kinds of work which are needed for the efficient prosecution of a war are much more suitable for direct control than others. A man whose war work consists in doing something totally different from what he has been accustomed to do in peace-time will generally be content to work strictly under orders; he will work more efficiently if he is told what to do than if he is left too much to his own initiative. But those people from whom it is required that they should continue to work at their ordinary trades may well feel that they know more about the work they are doing than the controllers who may be set over them;[1] control may be resented as interference, and a higher degree of efficiency may be secured by leaving the ordinary economic stimulus—the profit motive—in operation, and guiding business activity into the desired channels by the invisible pressure of the market. A good example, where this sort of indirect pressure may be particularly advantageous, is that of the export trades; export trade may be very important in war-time, and yet it is always secondary in importance to the war industries themselves; it needs an immense amount of adaptability, both in order to adjust itself to rapid changes of political conditions in its foreign markets, and in order to make do with the productive resources left over to it from more urgent needs; although even here there has to be a certain framework of control, it can hardly be doubted that the only way of securing a flourishing export trade is to leave a large amount of scope for private initiative.

A second reason why there may be some aspects of the economic system which are better guided in some other way than by centralized control and direction is the difficulty of co-ordinating control when it has to be carried out over so enormous a field. This difficulty is particularly intense in war-time, not only because of the magnitude of the activities which have to be co-ordinated in any case, but also because of the rapid changes in available supplies

[1] This difficulty is not very satisfactorily overcome by the device, largely adopted by the British Government in the present war, of delegating control to people 'in the industry'. With the best will in the world, such persons must find it difficult to achieve a proper subordination of the interests of their industry to the interests of the nation. State control is easily transmuted into a bargain between the State and a powerful interest, in which the State is not always the better bargainer.

and immediate objectives, which are an essential characteristic of war. To organize a system of control which shall direct the economic activities of a whole nation is hard enough; to improvise such a system, and re-improvise it each time there is a fundamental change in the situation, is even harder. There is something to be gained from economizing central direction, and not wasting it on the less urgent purposes.

It is true that as a war goes on, more and more of a country's economic activities are likely to be brought under public control; but this progressive socialization comes about, not as a result of deliberate policy, planned from the start, but in consequence of a series of emergencies, which bring one branch of economic activity after another into intimate contact with the war effort. The first effect of such an emergency often shows itself in the form of a sharply increased demand for certain sorts of labour and materials, a demand which has to be satisfied urgently. Methods of securing those resources by control and regulation take time to organize; in the meantime it may be necessary to use the profit motive as a means of getting them together as quickly as possible. Even if requisitioning is used at once, the offer of generous compensation has the advantage of securing co-operation and goodwill from those who have for the moment more knowledge than the authorities possess of where the required resources are to be found.

The case for some utilization of economic incentive in war-time is thus based upon the practical impossibility of bringing the whole of a nation's economic activities under control—or at least under effective control. Indeed, the control which is imposed upon the productive system is never so thorough-going as it appears to be at first sight. Save in the war industries proper, control takes the form of prohibitions and limitations, rather than of commands; a considerable amount of initiative within the regulations has to be allowed, or industry could not function at all. It is here that the economic incentive has an essential part to play. When materials are being rationed, and labour drafted off, the successful search for substitutes is a positive contribution to the war effort; but it is essentially the same kind of activity as makes for efficient business management in peace-time,[1] and which is directly stimulated by the profit motive. In order to earn good profits it is essential to

[1] 'The alert business man . . . ceaselessly applies the principle of substitution with the purpose of increasing his profits' (Marshall).

keep a watch on costs; in time of war it is just as desirable as ever to keep a watch on costs, so that there may be due economy in those things which are in short supply, and to prevent waste. It is not at all surprising that the last war should have been followed by an 'Anti-Waste Campaign'; waste, both conspicuous and inconspicuous, of scarce resources is the natural consequence of incomplete public control, sufficient to deprive the ordinary controls of private enterprise of their efficiency, but insufficient to take their place altogether. If the profit motive can do something to check this waste, it may have, even in war-time, a valuable part to play.

Improvised control is necessarily imperfect; and yet that part of the economic system which falls outside the control, or escapes between its meshes, has its own relation to the war effort, and needs to be directed into those channels where it can be most useful. A means of directing it is needed, and a means that can, if necessary, be very quickly applied. The ordinary economic incentive, working through the price-system, can supply such a means of direction; thus it is difficult to deny it some part in the war organization, though the part can be smaller the more efficient the direct controls can be made.

This is the case for allowing some scope to economic incentive in war-time. It is, so far as it goes, a good case, though there are weighty things to be said on the other side. The inequality of incomes is always one of the sore spots of modern society; when severe sacrifices have to be imposed on all classes, inequality of sacrifice may become a danger to national unity. New inequalities, which have not even custom and familiarity to recommend them, are less to be borne than old. The sense of unfairness is particularly aroused when the high incomes are earned, not by those who are in the centre of the war effort, but by those who are on the edge of it. As we have seen, this is just what is likely to happen. It is not the soldier who needs an economic incentive, but the civilian wage-earner; not the manufacturer of munitions, working under direct government supervision, but the producer who is less thoroughly controlled, because he is working in a trade less wholly given up to the immediate purposes of war. It is undoubtedly because of this feeling of unfairness that most of the schemes we are going to study have been imposed; even if it is recognized that the economic incentive to efficiency may be

damaged by them, they are still considered to be justified as means of fostering national unity and maintaining morale.

From the statesman's point of view this justification may be complete. In spite of the power of propaganda, he has, in the main, to take public opinion as he finds it, and suit his policies to what it dictates. From the point of view of public opinion, it is not so complete a justification. If the economic incentive does in fact make a net contribution to the efficiency of the war effort, a State which has to do without its assistance in order to maintain morale is in a weaker position than one which can maintain morale without making such a sacrifice. The statesman may be justified in yielding to agitation for social justice in war-time; but mistimed agitation, even for the worthiest aims, may not be justified itself.

The question then is: Does the economic incentive make a *net* contribution? That it has something to contribute we have shown; but if, in the process, exceptional incomes are not only earned, but spent, then there will be something to set on the other side. Through improvement in the efficiency of production, the national output is increased; whether the increased output takes the form of goods directly needed for warfare, or of goods whose function is to prevent the general standard of living from falling dangerously low, does not matter for this purpose. But if this increased output is only secured at the price of increased consumption by certain classes, then the utilization of resources to maintain this consumption has to be set against the gain from increased efficiency. In fact, there is waste either way. If the economic incentive is not used, there is waste from inefficiency; if it is used, there is waste because of the resources which have to be used up in supplying the economic incentive. The two have to be weighed against one another.

Closer economic analysis shows that the point is even more important than appears at first sight. The function of the economic incentive is to call forth supplies which would not otherwise have been forthcoming, to induce economies which would not otherwise have been made. This is what it is for; but in order to get this function performed it is usually necessary to confer the same advantage in other places where the job would have been done without the incentive being given. A rise in price leads to an increase in output; but the higher price has to be paid, not only on the additional units, but also on those units which would have

been produced just the same without the rise in price. A rise in wages attracts labour to a particular centre; but the people previously working in that centre have also to be paid the additional wages. If we rely upon the price-system to provide increased supplies it will provide them; but considerable parts of the additional incomes accruing to the producers will not contribute to the increase in supply, being (to use the traditional terminology) 'in the nature of rent'. The fact that considerable quantities of resources, which might have been used for more important purposes, are likely to be occupied in providing these 'rents' is a very bad mark against the economic incentive in war-time.

However, it is important to notice that such resources will only be absorbed if the additional incomes are spent; if they are saved and lent to the government no similar strain will arise. Of course a bill will mount up which will have to be met some time or other (we shall come back to that question later); but since it is held over until after the war, it does not have any effect on the war effort itself. The more people can be persuaded to postpone the expenditure of incomes earned during the war, the less is the economic objection to stimulating them by giving them the chance of earning high incomes.

These appear to be the main things which have to be said on each side; but it is easier to set out the *pros* and *cons* than to sum up the argument. Tentatively, one may conclude that in the early stages of a war[1] it is wise to leave a good deal of scope to the economic incentive; later on it may be desirable to circumscribe it more severely. So long as a large part of the nation's industry is operating under peace-time conditions, it must be left with the peace-time incentives. So long as the war controls exist only on paper, or are only finding their feet, they cannot usefully dispense with the ordinary method of enlisting the co-operation of specialized assistance—by paying for it. Later on, if the controls function well enough, they may be able to rely much more upon administrative direction; and the advantage which would still be gained by retaining much degree of economic incentive may be outweighed by the costs of securing it.

The taxes on war wealth, which we are going to study, are

[1] Or active preparation for war. From this point of view Germany was at war long before March 1938; America was already at war in June 1940.

dangerous expedients so far as they check the economic incentive to efficiency. But they are useful expedients if they succeed in reducing the cost of obtaining that efficiency, and in distributing the economic burden of war in a more equitable manner. These are the essential questions which have to be asked about the various taxes; we shall proceed to take them up in later chapters. But before we can do that, there are some other matters which need investigation. The extent to which exceptional incomes emerge in war-time depends very much upon the general financial and monetary policy of the government. One of the best ways of controlling them is through general financial policy, rather than through special taxes. In any case, we cannot discuss the special taxes without being clear about the process of monetary expansion against the background of which they have usually been placed. To that subject we shall now turn.

CHAPTER II

WAR WEALTH AND THE MECHANISM OF INFLATION

In a country whose economic system retains any of the characteristics of free enterprise, the transition from peace to war, and often each successive phase of war, results in a considerable shift in the relative demands for different sorts of goods and services, and consequently in the relative incomes of those who are able to provide them. This shift comes about partly as a consequence of the government's demand for war goods, partly because of changes, induced by war, in the intensities of demand for different sorts of goods by private people. And then there is a corresponding effect on the supply side. War always enhances the difficulty of production, at least through the dislocation of foreign trade, sometimes through actual invasion or air attack; but some commodities are more affected in this way than others. People who have the skill which is needed for making the scarce commodities find their services more in demand; people who possess the equipment or materials needed find their property more in demand; in either case their incomes are likely to rise relatively to the incomes of people who do not possess these particular advantages.

It is this shift in relative incomes which is responsible for the problem of war wealth. Although the popular idea of a profiteer is of someone who actually makes himself better off as a result of war scarcities, in practice the question is a good deal wider than one of profiteering in this sense. It is a necessary consequence of the cost of war that the average standard of living should be somewhat reduced; this means that it is perfectly possible for a person's income to rise somewhat relatively to the average without his being any better off than before the war. The taxes which we are going to consider do often fall upon people who have only made a *relative* gain in this sense; it even occurs upon occasion that people become liable to them whose standard of living has fallen relatively to the average. But even in these latter cases, it is still the purpose of the tax to offset the change in relative incomes which has been brought about by the operation of economic forces during the war; that can be done, either by a special

tax on war gains, or by a general tax, graduated so as to fall with greater force upon those whose incomes have relatively risen.

It is, no doubt, the original idea behind every tax on war wealth that it should fall upon profiteers in the narrower sense, upon those people who would actually gain out of the war, if no special tax was levied upon them. But the scope of the tax is at once widened as soon as it is laid down that the measure of gain should be a measure in terms of money—money, which is such an unreliable thing in time of war. The actual scope of the tax becomes very much a matter of monetary policy; a fall in the value of money will bring in more and more people who have not made absolute but only relative gains. In the absence of inflation, taxes on war wealth are only rather minor measures to check profiteering; once inflation takes place on a considerable scale they become transformed into general taxes which may be important sources of revenue. The presence or absence of inflation makes such a difference to the problems we shall have to discuss that it seems desirable to give some preliminary attention to the general mechanism of the inflationary process in war-time.

In order to clarify the working of the inflationary process, it is necessary to begin with some remarks on the character of a war economy as it would be if inflation were altogether absent. There is no close agreement among economists about the exact sense in which the word inflation should be used, consequently about the meaning of the statement that no inflation has taken place. We shall take absence of inflation to mean that the general level of money incomes is stationary. This is, perhaps, a more restrictive sense than that in which the term inflation is most commonly employed, but it has the advantage of being clear-cut; it seems to be the most convenient for our purposes.

If a belligerent government sought to avoid inflation in this sense, it would have to cover the greater part of the cost of the war out of taxation. The increased expenditure by the government would then be matched by a corresponding reduction in the expenditure of private persons. Since the government expenditure would be laid out on very different things from the private expenditure which it would replace, and since there would also be considerable shifts in the distribution of private expenditure, it must be expected that the demands for some things would go up considerably. But these increased demands for some things would

be matched by diminished demands for others. Wages would rise in some industries, but in others (where the contraction in demand more than counterbalanced the withdrawal of labour) unemployment would appear, or wages fall; abnormally high profits would occur in the expanding industries, abnormally low profits (or losses) in the contracting ones. The average level of money incomes would remain steady; rises in some incomes would be matched by falls in others.

Even with a steady level of money incomes, there would still be some rise in prices, due to the increased difficulty of production in war-time. Either because of direct losses through enemy action, or because of the measures which have to be taken for protection against such losses, a given volume of goods will require more labour and capital to produce it than would be necessary in time of peace. Some rise in prices must be expected to occur from this cause.[1]

The necessary fall in the average standard of living will be only due in part to this rise in prices; it will be mainly due to increased taxes. If the level of money incomes is to be kept steady, a large part of those money incomes will have to be abstracted by the government in order to pay for the war. In both these ways a person whose nominal income remains unchanged will find himself worse off. But the fact that the average level of money incomes is unchanged does not mean that all people are in this position. Some people's standard of living will be further reduced by a fall in the money incomes out of which they have to pay their taxes; other people will get higher money incomes, in extreme cases even high enough to compensate them for the heavy taxes and the high prices, so that they are actually left better off than before the war. It is only in these extreme cases that there would be a real gain out of the war; but even in the absence of inflation a nominal gain in money incomes might be made by a considerably wider class. For the purposes of war-wealth taxation, it would be this wider class who would come within the potential scope of the taxes; justifiably enough, since although they might not be making any net gain out of the war, the economic burden would be falling

[1] If the number of commodities affected in this way is not too large, it may be possible to keep their prices from rising by subsidizing them. But if this is done, there will be some degree of inflation unless additional taxes are raised to cover the subsidies.

upon them (in the absence of any special tax) to a less extent than on many of their fellows.

This is the position in the absence of inflation: a useful case to begin with, though not a very realistic case, since it is an almost unheard-of thing for any government to finance a war in so restrictive a manner. The reasons why inflationary methods are nearly always adopted seem to be twofold: first, the social and political obstacles to increased taxation; secondly, the continual appearance of new and essential items of expenditure, which cannot possibly be covered by taxation without some delay, during which the inflationary process begins. These are explanations rather than excuses; there is also the valid excuse that an over-restrictive method of finance involves diminished demand for labour in certain industries (as we have seen), and this is likely to result in unemployment. Some rise in total expenditure (public and private together) is necessary in order to ensure that the available resources are employed to the maximum intensity.

Inflation only sets in when the increase in government expenditure passes beyond what can be covered (*a*) by increased taxes, (*b*) by savings which would otherwise have been spent (or lent to business-men and spent by them) but are now lent to the government, (*c*) by funds in the possession of business-men (depreciation funds and the like) which would otherwise have been spent but are now lent to the government. Then (*d*) money spent abroad out of foreign securities acquired by the government from its citizens in exchange for war loan does not have any important inflationary effect *at home*; and similarly (*e*) if it acquires stocks of materials or other property from its citizens in exchange for war loan there is also no inflationary effect, so long as they do not seek to replace these stocks, but are prepared to hold the war loan instead. Taking these things together, it is evident that a government can borrow very substantial sums in war-time without causing any expansion in the aggregate demand for domestic goods and services; it can go even beyond this point without the inflation becoming dangerous, for an increase in the aggregate demand does call forth some increase in aggregate supply, so long as there are unemployed to be absorbed and people to be induced to work harder.

However, a point can be reached when all these resources give out; it is not easy to fight a great war without reaching that point sooner or later.

When once the rate of government expenditure passes beyond this safe level, prices will rise beyond the point which is justified by war-time difficulties in production, and aggregate incomes will rise because of the increased sums which are being paid for the goods produced. Let us suppose that we start from a position in which the value of the national output is £100 millions a week, of which £30 millions are bought by the government, being paid for out of taxes and borrowed savings, and £70 millions are bought by private persons. If government expenditure rises to £35 millions, the total value of output will increase to £105 millions; if there is no possibility of increasing production any further, prices will rise 5 per cent. on the average. As a result of the rise in prices, the government will only get goods worth $\frac{100}{105}$ of £35 millions, i.e. £33$\frac{1}{3}$ millions at previous prices; private people will get goods worth $\frac{100}{105}$ of £70 millions, i.e. £66$\frac{2}{3}$ millions instead of £70 millions.

This is the first phase; if the government should fail to collect by tax or loan any of the additional incomes earned, the same process will be repeated in the second phase, even without any further increase in the rate of government expenditure. For in the second phase the government again spends £35 millions; if it fails to collect from the private incomes any more than the £30 millions it did before, private people will have £75 millions to spend instead of £70 millions. Consequently the total value of output will rise to £110 millions. Prices will rise another 5 points. The Government will get goods worth only £31$\frac{9}{11}$ millions at the original prices, private people goods worth £68$\frac{2}{11}$ millions at the original prices.

In the third phase the same process will be repeated. But now it must become obvious that the government is unlikely to content itself with spending the same amount of money, when that constant sum of money is continually falling in real value. The government's expenditure is likely to rise in terms of money, and this accelerates the inflation.

If this were the whole story, further repetitions would soon end in collapse; fortunately it is not so bad as that. We have assumed that, in spite of the rise in prices and incomes, the government's receipts from taxes and loans out of income do not rise; this is too unfavourable an assumption, though it was desirable to begin with it in order to clarify the nature of the process. Receipts from taxes are bound to rise to some extent. Higher incomes mean larger receipts from income tax (more than proportionately larger, if the

income tax is progressive); although not all tax receipts will rise, it is in any case reasonable to expect the total yield of taxation to increase in at least the same ratio as the price-level. If the tax system includes a drastic tax on war wealth (such as an excess profits tax), the yield of taxation may well increase more than this. For the effect of the rise in prices is to enlarge the scope of such a tax; not only do the old taxpayers pay more but new taxpayers become liable. However, excepting in the extreme case of completely confiscatory war-wealth taxation (so that not only all excess profits, but also all excess wages and salaries, were confiscated by the government), the increase in tax receipts could not be sufficient to stop the inflation altogether. The most drastic 'excess' taxation which is at all probable in practice would be unlikely to increase government receipts (on our figures) to more than £32 or £33 millions; and this would still be insufficient to cover the whole £35 millions necessary.

This tendency of increased incomes to come back to the government in the form of increased tax receipts represents a distinct easing of the inflationary problem; but it is not so much of an advantage as appears at first sight, because even in the absence of such taxes, there would still be a tendency for some part of increased incomes to be returned to the government in the form of loans.[1] In so far as the increased incomes which accrue to private people are profit-incomes, it is quite likely that they will not be distributed to any considerable extent, or at least only distributed after some considerable delay. It is a question of the degree of conservatism shown in business policy. If business management is reasonably cautious, it is quite likely that (even without any special measures taken by the State in this direction) the increased profits which accrue from inflationary expenditure will be treated as capital gains (temporary gains, that is, not likely to recur), and saved rather than distributed. So long as the saving takes the form of in-

[1] *This tendency is of considerable importance even in the case when the* greater part of the increased incomes is ultimately collected in tax. For one of the principal weaknesses of the tax check on inflation is the delay which must ensue before most sorts of increased taxes can be collected. When inflation has proceeded far enough for people to count upon its continuance, this delay becomes very serious; but in the earlier stages it is not so serious, because people will be disinclined to spend money which they know will be needed to pay their taxes. The money will mount up in bank balances, which will be borrowed by the government until the time comes for the debt to be cancelled by actual payment of the tax.

vestment in war loan, or even of the accumulation of bank balances, it is a brake on the expansion of total expenditure, and is equivalent to an increase in the funds at the disposal of the government.

In so far as the increased incomes accrue to wage-earners or salary-earners, although there is some chance of the same sort of thing happening (the excess over normal earnings being regarded as temporary and therefore saved), it is obviously much less to be relied on. (Even if there were no other reason, there is the fact that wages are paid out at shorter intervals than dividends.) Consequently the expansion of total demand, and thus the inflation, will proceed less rapidly if the increased incomes are mainly profits than if they are mainly wages. Attempts by the workers to force up wages at the expense of profits, to shift the distribution of the increased incomes in favour of labour, will accelerate the rate of inflation. The reason for this is simply that more will be saved (and paid in taxes) out of profits than out of wages; the profiteer is of more use as a collector of funds for the government than the wage-earner.

Let us return to our previous figures, and see how they look when we have made allowance for these further points. In the second phase, instead of private expenditure amounting to £75 millions, it will be diminished by the additional taxes and the additional savings, so as to amount to (perhaps) £72 millions only. The total value of output will be £107 millions, not £110 millions; prices will rise 7 per cent. instead of 10 per cent. above their starting-point. The government will get goods worth £32½ millions at the original prices, definitely more than it would have done otherwise. The rate at which it would have to expand its money expenditure in order to get the same volume of goods is diminished, and the whole inflationary process is slowed up appreciably, though it is unlikely to be brought to a stop.

Meanwhile, the volume of goods purchased by private persons will be worth £67½ millions at the original prices, against the original £70 millions. If the amount spent out of wages has risen, but the amount spent out of profits has not risen (or not risen so much), then the volume of expenditure out of profits will have fallen more than the volume of expenditure out of wages. If, for example, we assume that expenditure out of wages is £50 millions initially, and has risen to £52 millions, while expenditure out of profits is £20 millions throughout, the volume of goods purchased

by wage-earners will have fallen by 3 per cent., the volume of goods purchased by profit-receivers will have fallen by 6 per cent. But of course, in the absence of special taxation, the receivers of profits will have additional government stock to the extent of £2 millions to their credit, on which they may be able to draw at some time in the future. The difference which will be made if there is a special tax on excess profits is that some part of this accumulation of debt will not take place.

This is the general picture of the mechanism of inflation which we need to have in our minds. There are several things about it which need particular emphasis. It will be extremely difficult to tell when such a process is really under way. A rise in prices is not an infallible symptom; some rise in prices would take place in war-time, even if inflation were absent. A large government deficit is not an infallible symptom; the government can borrow extraordinarily large amounts without any inflation being induced. Still less can inflation be inferred from a rise in the note circulation or in the volume of bank deposits; there are such good reasons why the troublousness of the times should make people desire to hold more of their wealth than usual in an easily disposable form, that failure to increase the monetary circulation to some considerable extent would be actually deflationary. A dangerous degree of inflation sets in when money incomes begin to rise without output rising; probably the clearest symptom is rising wage-rates in trades which are not particularly stimulated by war conditions.

Even when an inflationary process has begun, there is no reason why it should be allowed to continue. By the imposition of heavier taxation, or by other restrictions on consumption (sufficiently drastic to compel people to save a larger proportion of their incomes), a check can be put upon it; in war-time it is generally possible to take the steps which are necessary to prevent the situation getting really out of hand, when the need for them is apparent. Nevertheless (since new objects of military expenditure are continually coming up), even if the process is checked, it will probably be resumed.[1]

[1] It is sometimes supposed that a country which is dependent upon foreign trade cannot allow itself even a moderate degree of inflation in war-time because of the effect on exports. This danger is probably exaggerated, at least in present-day conditions. During 1933–9 the Germans discovered how to reconcile a successful export trade with an overvalued currency; while the path of bilateral

Experience seems to suggest that the danger of inflation is most serious after the end of hostilities. It is not hard to see how this comes about. War expenditure does not stop abruptly; it hangs over after peace is declared, and dies down gradually. Meanwhile, all the private and business expenditure which was postponed during war-time will wait no longer. Stocks which were allowed to run down will need replenishing; machinery which is worn out will need renewing; war damage will need to be made good; clothes will need renewing, houses redecorating, and so on. It is important to realize that the saving which takes place in war-time is largely postponement of expenditure, not permanent saving. The danger-point of inflation is when that postponement comes to an end.

For these reasons the end of a great war is likely to be followed by an expansion of public and private expenditure taken together, an expansion occurring in conditions very unfavourable to the formation even of those secondary savings, which appear as part of the inflationary process, and which can be relied upon to do much towards slowing up inflation during the war. Part of the war bill has been met by putting off the day of reckoning; and the time has come when the reckoning can be no longer delayed. Ideally, the right way to meet the situation would be to put up taxation drastically; to pay off part of the war debt by increased taxation. But in a time of weariness and relaxation this may not be feasible politically.

An alternative method of controlling post-war inflation is by direct monetary restriction, working through a rise in interest rates. Since this method appears to have been the one actually used in Great Britain during 1919–20, it deserves some special attention.[1]

agreements and negotiated exchange rates is not one which it is desirable to follow, nevertheless it always can be followed if necessary, and doubtless will be followed if the occasion calls for it.

[1] Whether the boom of 1919–20 would have come to an end without catastrophe in the absence of this monetary restriction is an arguable question; yet, however it is decided, the practical issue remains. Even if monetary restriction was not absolutely necessary then, it (or something to take its place) might be absolutely necessary on another similar occasion. A post-war boom will degenerate into runaway inflation if the length of time for which abnormal rates of public and private expenditure continue simultaneously is long enough to engender loss of confidence in the currency and an expectation of continually rising prices. On another occasion the period of simultaneous pressure might be longer, or confidence might be lost more rapidly.

Excessive government borrowing will always raise interest rates (that is to say, excessive supplies of government stock will lower its price), unless exceptional measures are taken by the banking system to support the flagging market. During the last war such measures were either not taken or only taken intermittently; in consequence there was a rise in interest rates in all belligerent countries as the war proceeded. The rise was due to insufficient control over the banking system (and to the persistence of ideas proper to Gold Standard conditions, but which were already out of date when the Gold Standard was *de facto* suspended); it caused governments considerable inconvenience. Nevertheless it had certain advantages from the point of view of limiting inflation. Almost all those firms which possessed investments of any kind found the capital value of their investments falling as the rate of interest rose;[1] some part of the profits earned out of the inflation had to be set aside to cover these capital losses.[2] Thus there was a further incentive to a conservative dividend policy; the sums available to be spent out of profits (which are what go to feed the inflation) were somewhat cut down.

After the war was over, the advantage in limiting inflation was even more important. The fall in gilt-edged securities continued (it could only have been avoided by much more support than the banks gave or were allowed to give); consequently investments could only be realized on very unfavourable terms, and the amount of spendable funds which business men could get into their hands

[1] Since the inflationary profits were only expected to last for the duration, equities shared in the fall in values as well as fixed-interest stocks.

[2] Naturally the most striking instance of this is the case of the banks themselves. During a war inflation the earning assets of the banks increase in more or less the same proportion as the total monetary circulation; unless special measures are taken to prevent it happening, their gross profits will probably increase in much the same proportion. This is, as we have seen, a more rapid increase than the general increase in incomes, to which the rise in bank costs is likely to conform more closely. Net profits will thus rise more than proportionately to the general rise in incomes; though when the disturbance is over, and the velocity of circulation returns to a normal figure, the discrepancy will disappear, and the profits of the banks will return to a level which is no larger in real terms than before the inflation started.

This seems to have been the experience of the principal British banks during the war of 1914; but the exceptional profits of war-time were largely cancelled out by losses due to the depreciation of investments. To-day bank costs are rising more steeply, and gross profits are more strictly controlled; so that (quite apart from E.P.T.) it is not very likely that the net profits of the banks will expand as rapidly as they did last time.

in this way was severely limited. Rather than sacrifice their investments at a serious loss, they might try recourse to the banks; but by this means the control of expansion was put directly into the hands of the banking system. Rising interest rates are a very effective way of checking inflation when it is an expansion of private expenditure which is at the root of the trouble.

Nevertheless, although the interest method is an effective check, it is a very costly check; its consequences go on being felt for years in two different ways. When once interest rates have been put up, it is not easy to get them down again; they may remain rather high for some time, and act as a brake on industrial activity in time of peace, whose importance is disputed, but is probably appreciable. On the other hand, high interest rates add very much to the burden of the National Debt when it comes to funding; £10 millions borrowed at 3 per cent. cost no more than £6 millions borrowed at 5 per cent.

For these reasons it is fairly certain that belligerent countries will take full advantage of the powers of monetary regulation which their governments have acquired, and will rely upon the interest check much less in the future than they did in the past. This is probably wise policy; but its consequence is that war inflation is a little harder to control, and post-war inflation would be a good deal harder to control. If we cannot rely upon interest policy so much, we shall have to rely upon tax policy more; the problem of the right fiscal policy to pursue at the end of a war is greatly increased in importance. No full discussion of that problem can be given in this book; but it is one of the matters to which we shall have to pay special attention when we come to discuss our excess profits taxes and capital levies.

CHAPTER III

WAR DEBT AND ITS SIGNIFICANCE

BEFORE we can pass on to our main themes, there is one further general question which has to be considered: the question of War Debt. From the point of view of the whole nation the object of imposing heavy taxation in war-time is to restrict private expenditure and to keep down prices; but from the point of view of the Exchequer the object of the taxation is to retard the growth of debt. Since we shall have a good many cases to consider when these two objectives are best met by rather dissimilar measures, it will be useful to have some clear ideas about the significance of war debt, so that we may know what weight to give to the consideration that a particular measure will tend to increase or to diminish the debt burden. As it turns out, there is a good deal more to be said about the matter than might appear at first sight.

The discussions about the net burden of the National Debt which took place in England after the end of the last war have familiarized people with the idea that an Internal Debt is no net burden upon the community as a whole. It is a debt owed by one section to another section; the interest which has to be paid upon it is simply transferred within the community, from one group of citizens (the taxpayers) to another group (the bondholders), groups which partly but not wholly overlap. Considered purely as a question of national accounting, this is undeniably true. The total real wealth of a nation (the National Capital) equals the sum of all the assets of all individuals and institutions within the nation (including the State) minus the sum of all the liabilities. Now all debts and obligations which are owed within the nation (either by one individual or firm to another, or by private people to the State, or by the State to private people) will themselves appear as assets on one side of this balance-sheet, as liabilities on the other. Consequently when the totals are added up, all these internal obligations (including the internal national debt) will cancel out. The national capital becomes equal to the total value of all the real goods possessed by the nation within its own frontiers (whether they are actually owned by private persons, by firms, or by the State) plus foreign assets minus foreign liabilities. It is only the external

debt of the government which figures (as a negative item) in this final computation; the internal debt does not figure at all, because it has cancelled out.

What does happen if the State has acquired a large internal debt as the result of war is that the total value of Private Property becomes greater than the national capital. For the national capital equals private property (private assets minus private liabilities) plus public assets minus public liabilities. If public liabilities (national and municipal debt) are greater than public assets, private property will be in excess of national capital.

Thus at the end of a war some part of the private property of individual citizens will consist, not of real goods (or of claims upon firms which possess real goods), but of claims against the State. Corresponding to these claims upon the State, there will be no real goods outstanding, nothing but the possibility of meeting the interest on these claims out of taxation. It might appear at first sight as if the accumulation of such claims could only take place through the accumulation of war wealth—that this particular kind of property amassed during the war is itself a symptom of profiteering and a particularly obnoxious form of profiteering, since its effects go on being felt long after the war is over. To some extent this may be true, but it is not by any means necessarily true, as can be seen quite clearly if we look at the formation of the debt with our classification of the national capital in mind.

The national debt accumulated in war-time may be divided into three parts: (A) External Debt; (B) Debt which arises out of compensation paid for private assets taken over and used up or destroyed; (C) Debt which arises out of the borrowing of new savings. Each of these parts may be further subdivided.

(A) External Debt is a wider category than is always allowed for. It includes not only direct debts to foreign governments (such as the British debt of 1917–18 to the United States), but also all that government stock which, though issued at home, is purchased by people domiciled abroad, or purchased by financial institutions by means of funds deposited with them by such people. All this external debt figures on the liability side of the national capital account, and there is nothing to set against it.

(B) There is one kind of Compensatory Debt which is very similar in its economic characteristics to external debt—that which is incurred to compensate particular citizens whose holdings of

foreign securities are taken over by the government and disposed of. In this case the nation has disposed of foreign assets, instead of acquiring foreign liabilities, but the effect on its international economic position is much the same. There is a net loss of national capital; the particular people who have acquired government stock in place of the securities which have been sold are no better off, while the nation as a whole is worse off. This department of debt therefore represents a part of the real cost of the war.

In addition to foreign assets taken over and disposed of, some of the real capital goods possessed by private people at the outbreak of war are likely to be taken over and used for war purposes. These goods have, of course, to be paid for (otherwise the requisitioning would be a most arbitrary and inequitable sort of capital levy); in all those cases when the goods cannot be replaced in the same quantities, a portion of the proceeds will be invested by the sellers—either directly in war loan, or by buying other securities from someone else who invests in war loan, or by lending to a bank which invests in war loan. Directly or indirectly, along one channel or another, what has happened is that the government has taken over real goods and given war loan in exchange. Once again there is a loss of national capital, with compensation for the original owners.

The same thing happens if the government gives compensation for property destroyed by enemy action; and the same thing again if depreciation funds, which would have been used for the replacement or maintenance of equipment, are lent to the government. Here the national loss consists in the deterioration of the equipment; the war loan merely compensates the particular owners.

Taking all these things together, it is evident that a considerable amount of debt can arise without any individual citizen being benefited; all the debt which we have classified under (A) and (B) represents a real loss of national capital.

(C) The position is different when we pass to that part of the debt which arises out of savings. If there had been no war, people would presumably have saved part of their incomes, and out of those savings additions to the national capital would have been financed. If the government borrows these savings and uses them to finance war expenditure, the war loan given in exchange may be said to compensate the savers for the absence of the new capital goods which would otherwise have been acquired out of their

savings. Yet, although this is a possible way of looking at the position, the compensation in this case is evidently of a very different character from that which we have previously discussed. The war loan which is issued is a net addition to private property without there being any addition to national capital; there is a very much better case for compensating people who are arbitrarily deprived of a part of their possessions as a result of the war than there is for compensating them when they merely lose the opportunity of getting more. A sound system of war finance will obviously aim at collecting in taxation as much as possible of the excess of incomes over necessary consumption, so that the scope for saving will become very small. Yet it has to be remembered that no tax system can possibly be constructed of such delicacy and precision that it will collect all the surplus between income and consumption which some people can readily be persuaded to spare, without inflicting cruel hardship upon innumerable others. Since it is all to the good in war-time if some people can be persuaded to reduce their expenditure even more than they are being compelled to do, some addition to private property which is not an addition to the national capital may be well worth while as a means of bringing this about.

It is true that some part of these savings will come from people whose incomes have risen as a result of the war, but who are willing to invest their extra incomes in war loan, instead of spending them. It is very much to the national interest that they should do this; extra goods can be provided for them much more easily after the war is over than during the war. If the offer of higher incomes to certain people does succeed in stimulating war production in those directions where it is most needed, then the nation which secures this stimulus in return for a draft on the future may have made a very good bargain. Higher incomes which do not result in any such stimulus are, however, likely to occur, as we have seen;[1] their occurrence is one of the main objections against the use of supply and demand as a means for the mobilization of resources in war-time. If these 'rents' are saved and invested in war loan, it is better for the nation than it would be if they were spent; but the increase in the national debt resulting from savings of this sort is a burden upon the community for which it has got nothing in return. This is the only part of the war debt (it may not be a large part) which

[1] See above, pp. 6–7.

does correspond to a genuinely reprehensible form of war wealth; but the problem raised by debt of this sort is exactly the same as the problem of war wealth which we have previously discussed.

What, however, of inflation? The extra savings which occur in the inflationary process do not require any new heading. Inflationary savings are perfectly genuine savings, in the sense that each saver could have spent his money if he had wished, and could thus have acquired extra goods at the expense of other people or of the war effort. The volume of savings in terms of money will be enormously increased, because higher incomes are being received by numbers of people who, on account of the rise in prices, are worse off rather than better off as a result of the war. But all this can still be fitted into the classification we have given.

Where inflation does complicate the problem very seriously is over the distribution of the debt among the various headings—it becomes much more difficult to distinguish one type of debt from another in an unambiguous manner. Inflation raises the value of the national capital in terms of money, just because the prices at which the various goods come to be valued go up. This means that if we persistently think in money terms without any correction, we shall find that the national capital has actually risen as a result of the war, instead of falling, as it must almost certainly do in physical terms, or in terms of a money with stable value. If a large part of the war debt has to be added on to the national capital before we get a figure for total private property, then (thinking throughout in terms of money and paying no attention to changes in its value) it will appear that there has been an enormous increase in private property as a result of the war; incomes have been immensely inflated, a large part of these inflated incomes has been saved, and the result has been to increase private property, not only by the amount of the debt, but by a good deal more as well. This is how the situation appears when we refuse to take account of the changing value of money, but when the refusal is carried to this point it becomes obviously absurd. We ought, so far as possible, to look at the situation as it would work out in terms of a money which was more stable in value. When we do that, it turns out that the inflation does not make so very much difference, excepting that it causes a violent redistribution of property among property-owners, a redistribution in favour of debtors against creditors, in favour of ordinary shareholders against bondholders,

and so on. The general principle that the war debt is in large measure a compensation for the loss of property due to the war still holds in spite of inflation; though in view of the redistribution of property which takes place as the result of inflation, it must be confessed that the compensation is only too likely to get into the hands of the wrong people!

Nevertheless, when we take this last point into account, it becomes rather a question whether we ought to confine our definition of compensatory debt to the debt which arises directly out of compensation actually paid for private assets taken over. It will often happen that adequate compensation in money is given at the time, but, as a result of the depreciation of money during the war, the real value of the compensation turns out in the end to be much less than that of the asset which was used up. Yet if some people make real losses as a result of inflation, others make real gains. There is much to be said for reckoning as compensatory debt all that debt which offsets the loss of other assets incurred by all property-owners together. In the absence of inflation this will be approximately the same as our earlier definition; its principal difference from the earlier definition arises out of subsequent depreciation of the money in which compensation was paid for assets taken over near the commencement of the war.

The importance of this revised definition becomes clear when we pass on to consider the post-war debt problem. There is then a vital distinction between that part of the internal war debt which offsets a real loss of national capital (the Compensatory Debt) and that part which has arisen out of the borrowing of war savings (the Paper Debt, as we may call it). Even an increase in paper debt is a serious matter; the payment of interest upon it involves a transference of income from one section of the community to another, a transference which has to be made through the budget and which is bound to cause a certain amount of trouble, since it is unlikely to have any particular social purpose at the time when it is made. But it is a much less serious matter, even from the point of view of the budget, than an increase in the other sorts of debt, those sorts which do represent a real reduction of national capital, which is part of the real cost of the war. External debt and compensatory debt are a charge upon the budget; but against this charge there is no increase in the property of taxpayers, nor in consequence in the incomes they derive from that property, nor in consequence in

their ability to pay taxes. With the paper debt it is another matter; for with the paper debt there is an increase in taxable capacity, in the revenue which will be derived from given rates of taxation, and this goes some way towards offsetting the expenditure on interest. How far it will go depends upon the system of taxation employed, and upon the distribution of holdings for paper debt among different classes; it can never offset the interest cost altogether, but in some cases it may reduce the net burden upon the budget very considerably. This is particularly likely to happen when the system of taxation is highly progressive, as it is in Great Britain; such countries will be incommoded remarkably little by a large paper debt, especially when it is in the hands of the relatively wealthy, who pay direct taxes at high rates.[1] No country can fail to suffer seriously when it loses a part of its real national capital; the paper debt, which does not correspond to any such loss, is altogether a slighter matter.

The principles which have been set out in this chapter may be easier to follow if we conclude by giving a statistical illustration. As a result of the researches of Mr. Campion,[2] it is now possible to give an analysis of the war debt accumulated by Great Britain during the war of 1914–18. Mr. Campion estimates the total private property of British people in the years 1911–13 at about £12,000 millions; since there was also public property of about £1,000 millions, against which a liability of something over £1,000 millions in national and municipal debt was outstanding, we shall not go far wrong if we reckon the national capital as at this date substantially equal to the total of private property—£12,000 millions. In the years 1926–8 (rather longer after the end of the war than we should choose, but the figures have to be taken as we find them), the total of private property is given as about £22,000 millions. In order to get the national capital, we must add about £2,000 millions of public property, and subtract about £7,000 millions of internal debt (national and municipal). This gives us for the national capital (apart from a deduction for external government debt)[3] about £17,000 millions.

Thus if we pay no attention to the change in the value of money,

[1] See below, chs. xxix and xxx.

[2] H. Campion, *Public and Private Property* (Clarendon Press, 1938).

[3] The £1,000 millions or so of external government debt may be left on one side as a thing apart.

it would appear that not only was there a great increase in national capital during the years 1912–27, but that a great accumulation of public debt in private hands took place in addition. If there had been no war, and if the years in question had been years of steady economic progress without any great change in the value of money, private property and national capital would both have increased, perhaps to £14,000 or £15,000 millions. Actually national capital was considerably more than this, and private property a vast amount more. Looking at the position in money terms, what happened was that there was a large increase in incomes during the war, very large amounts of these increased incomes were saved, and this led to an enormous increase in private property, in spite of the fact that the savings were so largely used in an unproductive manner. But in fact this increase is very largely illusory. There had been a large rise in prices between 1912 and 1927; an increase of national capital from £12,000 to £17,000 millions is hardly more than enough to compensate for the rise in prices. If we take the relevant rise in prices as 30–40 per cent. (which seems to be a moderate estimate)[1], then the £12,000 millions of private property in 1912 plus the accretions due to normal saving and investment in the ten years of peace (which are included in the fifteen years 1912–27) would be worth at least £18–19,000 millions, reckoned at 1927 prices. Obviously this is only a very rough estimate, but whatever we consider to be the right figure for the rise in prices, it is bound to leave us with the conclusion that the national capital was reduced at the end of the war in terms of a stable money,[2] while the total of private property was increased, but only to a moderate amount. In other words, an appreciable part of the war debt was compensatory debt, which merely offset the fall in national capital; the true increase in private property was not much more than a reasonable compensation for the real savings which had been made during the war.[3]

Nevertheless, this increase in private property must have

[1] Between 1912 and 1927 the cost of living rose by about 70 per cent., the wholesale price index by about 50 per cent. It is not easy to say which is the more appropriate for our purposes; but in any case the result needs to be somewhat corrected for the rise in interest rates (though it should be remembered that the yield on industrials rose much less than the yield on gilt-edged).

[2] How far this reduction was a reduction in physical capital, and how far it was a reduction in *net* foreign assets, it seems impossible to guess.

[3] This conclusion is rather at variance with that accepted by the Colwyn Committee; but see below, p. 265.

assisted very considerably in reducing the debt burden. If we suppose that the paper debt was no more than £3,000 millions, interest on this (at the 5 per cent. rate ruling in the twenties) would have been £150 millions, and £60 or £70 millions of this must have come back in taxation of various sorts. This was a real reduction of the net interest burden; if the corresponding sums had been raised in taxation during the war, instead of being borrowed, tax receipts would have been less by this amount, even if the same weight of taxation had been imposed.[1] The real weight of the paper debt—the sum which had to be raised from taxpayers in general and transferred to the bondholders—can have been little more than half of the nominal weight. The compensatory debt and the external debt, on the other hand, were a net burden.

[1] In addition to this real easing of the debt burden there was also an apparent easing, due to the fact that a rise in prices and incomes increases the receipts from a given system of progressive taxation. If prices and incomes are both doubled, a man with £2,000 a year is no better off than a man with £1,000 a year was under the old conditions, but if tax schedules are unchanged, he will pay a higher proportion of his income in tax. This is very satisfactory from the point of view of the revenue, but it does mean that the weight of taxation is increased. It is *not* the easing of the problem which we are talking about.

PART II

THE TAXATION OF EXCESS PROFITS

CHAPTER IV

EXCESS PROFITS OR EXCESS INCOMES?

THE first kind of tax on war wealth which we have to consider is the Excess Profits Tax; historically this has been much the most important variety. Let us begin by inquiring why this is so. The obvious reason—that profiteering is the form of war wealth which gets the greatest social obloquy—is not altogether a sufficient reason; for the profiteer can be reached in other ways than by a direct tax on profits. The fundamental reason why excess profits taxes have secured this pride of place is because they are the most efficient way of taxing war gains. It may perhaps be desirable to reinforce them by using other methods as well, but there is no other method which will replace them altogether.

Very much the best way of taxing wealth in general is the income tax; no other tax can raise such vast sums in so equitable, and so economically harmless, a way. Consequently it might seem at first sight as if the best way of taxing war wealth would be by an Excess Income Tax—that is to say, by a special surtax upon increases in income over the level of a pre-war standard period. Sooner or later, all war wealth accrues as somebody's income; from the standpoint of equity, everything seems to be in favour of taxing it at this stage. It is only by taxing excess incomes that due attention can be paid to the different economic circumstances of different taxpayers, so that more is taken from the rich man become richer than from the poor man become less poor. It is only by taxing excess incomes directly that the tax can be made to fall upon all sorts of excess incomes above a certain level; a tax on profits alone excludes not only the war bonuses of wage-earners, but also those war gains which accrue as higher salaries and higher professional incomes. There is no equitable reason why these should be exempted, nor is it usually desired that they should be. Yet unless the tax is imposed upon excess incomes of all sorts they will be exempted.

There is also a more subtle reason why the taxation of some

excess incomes only—namely profits—and not all excess incomes leads to unfairness. The boundary between profit incomes and other incomes is not very easy to define in detail; wherever it is drawn, it is bound to leave some hard cases, particularly in the professional field. Some professions are carried on by partnerships or even by private companies; it is not reasonable to tax these if the individual practising upon his own account is not to be taxed; nor is it reasonable to tax the independent practitioner if he is doing work which, in other circumstances, he might do as an employee. In practice, the dividing line is usually drawn by the nature of the occupation, not by the form in which it is organized. The British courts seem to distinguish a 'profession' from a 'trade or business' according as it demands 'intellectual skill' or 'is substantially the production or sale, or arrangements for the production or sale, of commodities'.[1] It is not clear that these definitions are mutually exclusive, nor that it can be easy to administer them in a way which is uninfluenced by the social prejudices of the age; nevertheless it is in some such way as this that the scope of a tax, which is to fall on profits, and only on profits, has to be defined.

All these difficulties could be overcome by an excess income tax; but in spite of these advantages, it has not been common for any great reliance to be placed upon the excess income tax as a means of taxing war wealth. The reasons for this have been partly administrative. In the first place—looking over the whole international field we are going to cover it is a remark we must not neglect to make—the imposition of a successful excess income tax is only possible if an efficient administration of ordinary income tax already exists. It is impracticable to tax increments of income arising during the war if the pre-war incomes of taxpayers are not known to the revenue authorities with a reasonable degree of accuracy. For this reason alone, an efficient excess income tax would have been impracticable in most of the belligerent countries during the last war—in Germany, France, Italy, America.[2] Secondly, even if this objection is absent, the mere fact that an excess income tax involves computation of *changes* in income means that it imposes a greater burden upon the revenue authorities than

[1] Scrutton, L. J. (1921), quoted in H. E. Seed, *The Excess Profits Tax* (1940), p. 18.

[2] Rudimentary excess income taxes were in fact imposed in Germany and (for a while in 1917) in the United States. But the results were what might have been expected.

an ordinary income tax does. Standards of assessment and collection which are good enough for an ordinary income tax may not be good enough for an excess income tax. It was a reason of this sort which seems to have been responsible for the rejection of an excess income tax in Great Britain in 1915. Ordinary income tax relied so much for its efficiency upon collection at the source, which would not be available for an excess income tax, that the Inland Revenue authorities felt themselves unable to guarantee the maintenance of acceptable standards in its collection. This is an objection which can hardly exist to-day. The new method of collecting income tax on salaries at the source does a good deal to strengthen the hands of the revenue authorities; though the difficulty of getting a full assessment of unearned incomes still remains, it should be observed that surtax, which does not rely upon collection at the source, is now an important source of revenue. If surtax can be collected with an acceptable degree of efficiency, why should not the same be possible for an excess income tax?

Such a question as this does not arise until a very high degree of fiscal efficiency has been reached; at any lower level, the administrative convenience of the excess profits tax is a strong argument in its favour. The information needed for carrying through an excess profits tax is mostly available in ordinary business accounts. If these accounts have had to be drawn up for income-tax purposes, they will be rendered more comparable with one another for this reason (for example, depreciation or wear-and-tear allowances may be calculated upon a more uniform plan). But even if this advantage is absent, something can still be done. Excepting for new firms (which always create a problem) something at least can be known about the situation of any firm in the pre-war period, simply from an examination of its past accounts. If the general standard of accounting in a particular country has not been high, more latitude will have to be given for fixing a reasonable standard by administrative action. But although this increases the arbitrariness of the tax, it does not make it impracticable.

The thorough investigation of business accounts, which in several countries (Germany, Italy, America) was first undertaken in connexion with the excess profits taxation of the last war, had consequences which went far outside this particular field. It

opened up new possibilities of taxation generally, and greatly increased the fiscal efficiency of the State. The improvement in German fiscal administration since the last war is particularly significant.

Supposing these administrative difficulties are overcome—it would seem that they can be overcome in favourable circumstances—can we then say that an excess income tax is the best form of war-wealth taxation? Hardly, if it is imposed alone; for there is still another difficulty which has to be met.

While those high salaries and professional earnings which are received during the war will be taxed by an excess income tax as they accrue, or after no more than an ordinary lag in collection, profits, although they must ultimately accrue to individuals in the form of increased dividends, may not be distributed as such for a long time, being used in the meanwhile to strengthen reserves. If additions to reserves are not liable to tax, there will be a great loss of revenue: a loss which is even more serious than that which would ensue if company reserves were exempted from the ordinary income tax. The excess income tax would be a temporary tax, due to be withdrawn sooner or later after the end of the war; thus if company reserves were exempted from it there would be a strong incentive not to distribute them in the present, but to keep them until the war was over, and the tax removed. This consideration makes it practically impossible to impose an excess income tax excepting in conjunction with some other form of taxation, designed to prevent this sort of evasion. In practice all the excess income taxes of which we have record have been supplementary to some sort of profits tax.

It is, however, conceivable that another method might be used. The taxation on war wealth imposed during the war might be confined to excess incomes; and the gains which escaped the excess income tax by being accumulated in company reserves might be annexed to the Treasury by a special capital levy on war wealth, to be imposed on the shareholders when the war was over. This is, perhaps, the ideal arrangement, from the point of view of equity among persons; but there are several reasons why it would be hardly likely to work out so well in practice as might be supposed at first sight. For one thing, as we shall see in detail later,[1] a capital levy on the increase of wealth during the war is

[1] See below, pp. 187, 270, 288.

the hardest sort of levy to work satisfactorily; a scheme which was dependent upon this sort of levy for its success would probably find the dependence a source of weakness. The fact that a company had accumulated large reserves during the war would not necessarily give its shares a high market valuation at the moment when the war came to an end; the shareholders might derive considerable advantages from these reserves in future years and yet they might evade the levy. Even apart from this difficulty, it has still to be observed that equity among individuals would not imply equity between companies. The shareholders in a company which had made large war profits might be subjected to the levy, and obliged to sell some of their shares to people whose holdings of war debt were being redeemed; they would lose their war gains, but the company would still retain its reserves, and would be in a stronger position relatively to other companies as a result of the war. This is, perhaps, a minor matter, but it needs to be taken into consideration.

Very much the most serious drawback to a plan of this kind is that it would leave the accumulated profits in the possession of the businesses which had earned them until the end of the war. If there was no control over the disposal of these reserves there would be nothing to prevent them from being spent upon new capital equipment; indeed, they probably would be spent in this way to a large extent, for when prices are rising it is more profitable to hold reserves in the form of goods than in the form of money or of securities. And yet this is a thing which could not possibly be allowed to take place without control; unnecessary purchases of capital goods are every bit as inflationary as unnecessary purchases of consumption goods. It is true that they can be hindered by rationing raw materials; but such rationing cannot be expected to work as efficiently as it would otherwise do, if economic forces are working strongly against it. It does, therefore, seem as if the blocking of reserves would be a necessary element in the sort of scheme we are considering; that is to say although the reserves accumulated out of war profits might be left in the possession of the firms which had earned them, these firms could not be allowed to dispose of them freely, but would have to be compelled to use them in an appropriate manner, such as in the purchase of war loan.[1] This is a possible arrangement, but it has to be noticed

[1] For further discussion, see below, pp. 48–9, and ch. VII, *passim*.

that its efficient administration would require almost identically the same organization and the same regulations as are required for the administration of an excess profits tax. It may indeed be questioned whether the blocking of war profits can be carried out efficiently except as part of the administration of an excess profits tax; for if an excess profits tax is in existence, it is perfectly easy to lay down that the purchase of a particular type of government security, non-negotiable until after the war, shall be accepted as an alternative to some part of the tax liability. If an excess profits tax is not there to act as a sanction, blocking can hardly be enforced.[1] And so we come back to the excess profits tax.

Thus our examination of the most plausible alternative to an excess profits tax has not really disclosed a means whereby the imposition (or at least the organization) of such a tax can be avoided; the excess profits tax is bound to retain its position as the central tax on war wealth. In spite of that, this preliminary discussion has not been a waste of time; for the various ingredients of the alternative solutions we have been examining—the excess income tax, the blocking of reserves, and the capital levy—may still have a part to play in a rational scheme of war taxation. Some of the defects of a pure excess profits tax have already appeared, and more will appear in later discussion; it is possible that some of these defects could be removed by a judicious admixture of some of the other measures. Yet if they are to be introduced it can only be as supplements to the excess profits tax, not as substitutes for it.

[1] The experience of the German dividend blocking (1934) seems to bear this out. See below, pp. 144–5.

CHAPTER V

HIGH PROFITS OR WAR PROFITS?

EXCESS profits taxes, being taxes on profits which exceed a certain 'normal' level, may mean different things according to the way in which the word 'normal' is interpreted. The profits earned by a particular firm in war-time may be in excess of 'normal' in the sense that they are more than what was earned by that same firm in time of peace; or they may be abnormal in the quite different sense that they represent a higher rate of return on capital than is common in industry, or more than what is generally supposed to be a reasonable rate. The more striking instances of excess profits will, of course, be *excess* in both of these senses; but nevertheless the two criteria do actually mark out distinctly different fields. Taxation which is mainly levied on the one sort of excess profits is a distinctly different matter from taxation mainly levied on the other.

For convenience we shall describe the first sort of tax as a War Profits Tax, since it is a tax on those profits earned during the war which are higher than the corresponding profits earned in peace-time.[1] The second we shall describe as a High Profits Tax —a tax on profits higher than some conventional standard of normality, which need have no particular relation to war-time conditions. It should be observed that, while a war profits tax can (from its nature) only be imposed in time of war or other exceptional circumstances, a high profits tax could conceivably be included in the regular fiscal machinery. In fact, whenever it has been suggested that an excess profits tax should be included in the regular tax system, it is the high profits variety which has been had in mind.

These are the two pure types of excess profits tax; but the taxes which are imposed in practice rarely conform to either pure type, being mixed varieties of one kind or another. The American tax

[1] We shall encounter some instances of war profits taxes in a narrower sense —taxes on profits arising *as a result of* the war (see below, pp. 158, 166). These taxes were always abortive, because it is administratively (and perhaps logically) impossible to distinguish those high profits arising during war-time which are a result of the war from those which are not. Thus these taxes are not sufficiently important to need a special category.

of 1917–21 was a pure high profits tax, excepting that a war profits tax was superimposed upon it during some of the months when America was actually at war (1918). The British E.P.T. (1939) is about as near to a pure war profits tax as is practically feasible; it makes the one necessary exception, taxing firms which did not exist in the pre-war period with a high profits tax (the percentage standard), and includes some limited provisions for the use of the same method in taxing firms which can claim that their pre-war profits were abnormally low. The British E.P.D. (1915) was a hybrid; the taxpayer had the choice between a profits standard (war profits tax) and a percentage standard (high profits tax), so that he was only taxed if his profits were above pre-war, and also above a normal rate on capital.[1] Another kind of mixture was employed in most continental countries during the last war. This was a war profits tax, charged at progressively higher rates as the rate of profit on capital exceeded certain defined levels; thus the high profits criterion was introduced to determine the progression. Nevertheless, in spite of these admixtures, it would be true to say that the European and British taxes have been mainly war profits taxes; the best examples of high profits taxes are Canada (1916), United States (1917), and Australia (1940). The American case is the one about which we have most information; so we shall find it convenient to study the peculiarities of the high profits tax principally in the light of American experience.

The American decision, in March 1917, to impose an excess profits tax of the pure high profits variety was no doubt due to the fact that they were not particularly concerned to tax war profits; they were seeking to draw upon the high profits which had long been common in their rapidly expanding economy, as a means of financing their war preparations. Ideally, they would have desired to look for all the money which had been invested in American business at any time, and to tax the surplus whenever the rate of profit now being earned upon that money exceeded a 'proper' standard rate. In the first crude legislation, the capital invested in a business was defined as nominal capital *plus* reserves; that is to say, the proprietors' or share capital set down on the liabilities side of the balance-sheet (borrowed capital being, of course, excluded) was taken to represent the money originally

[1] A rather similar device was used in some continental countries (e.g. Switzerland) whereby a minimum percentage on capital was always exempted from tax.

invested in the concern, and the accumulated reserves to represent the money reinvested out of undistributed profits at later dates. Afterwards it was realized that this was not good enough. By the issue of bonus shares and other stock-watering devices on the one hand, by the writing-down of capital on the other, the nominal capital shown in the balance-sheet of a firm can be made whatever it is desired to make it; the fact that a firm is earning a low rate of profit upon its nominal capital does not necessarily mean that it is earning a low rate upon the capital originally invested. But this difficulty was largely overcome in the later legislation; the capital invested in a concern was defined a good deal more carefully, so that the main kinds of watered capital were, at least in principle, excluded.[1]

No doubt these amendments made the tax considerably more reasonable; but the main source of inequity in a high profits tax could not be removed by this sort of adjustment. Consider the case of a profitable concern founded in 1900. Let us suppose that its high profitability has been apparent nearly from the start; over the greater part of its life it has earned about 20 per cent. on the capital originally invested. Assuming that it is still earning 20 per cent. in 1917, it will become liable to a considerable contribution to the tax. Now so far as the original shareholders are concerned this tax may be quite reasonably equitable; at least it will do what it is intended to do. But it is fairly certain that not all the capital of the concern will be owned by the same persons in 1917 as in 1900. Some of the original subscribers will have sold out in the interim and placed their capital elsewhere; if they sold out after the time when the high profitability of the concern became apparent, they would have disposed of their holdings at a considerably higher price than they gave for them. If they then invested these receipts in another concern whose rate of profit was not abnormally high, they might escape the tax altogether, in spite of the fact that they would still be earning a 20 per cent. return upon the capital they invested in 1900. On the other hand, those people who bought their shares in the original firm from them would be subjected to the tax, in spite of the fact that they would not be securing any abnormal return upon the capital they had invested themselves. The real trouble with a high profits tax—a trouble which cannot be avoided if there is, or has been, an active market

[1] See below, p. 128.

in stocks and shares—is that it must fall to a considerable extent upon the wrong people.

One must conclude that an excess profits tax of the high profits variety is necessarily a bad tax, because its discrimination among firms does not offer any basis for equitable distribution of the tax burden among persons. The only equitable way of taxing profits is by a general proportional tax on profits;[1] the stage for discriminating between low profits and high profits is when dividends are distributed, and become liable to income tax.

An excess profits tax of the war profits variety is in principle free from this sort of criticism. Ideally—and the ideal can usually be approached fairly closely in practice—the tax should be imposed as soon as possible after the outbreak of war, and the standard period from which the excess is measured should be as recent as possible, so as to leave as small an interval between the end of the standard period and the imposition of the tax as can be managed. If this is done, there will have been little opportunity for exchange of shares between the time when war profits begin to be anticipated and the time when taxation of those profits begins to be anticipated. The tax will fall, as it is meant to fall, upon those who are the gainers from the windfall profits of war.

To this principle there is only one important exception.[2] The price at which a company's shares are quoted depends, strictly speaking, not upon the profits it is actually earning at the moment, but upon the profits it is expected to earn in the future. If, for any reason, a particular concern was earning abnormally low profits in the standard period, it is possible that people might have been willing to pay a higher price for its shares than the price which would be got by capitalizing its current rate of profit. At the moment, the firm might have been earning no more than 4 per cent. on its nominal capital; but if people expected its earnings to rise later to 5 or 6 per cent. they would be willing to give more for its shares than they would otherwise be willing to give for shares in a company earning only 4 per cent. profits. Now if, when the profit does rise, the excess is taxed away, these particular shareholders are not deprived of a windfall gain; they

[1] This is the solution to which the Americans did come in the end. Their excess profits tax was replaced in 1921 by a surcharge on the ordinary corporations profits tax.

[2] Assuming that proper allowance is made for depreciation and wasting assets. See below, pp. 58, 97, 106.

are cheated of a legitimate expectation. It is reasonable that there should be some tempering of the wind in a case such as this.

Difficulties of this sort actually arise in two different ways. They arise in the case of trades with fluctuating profits, profits which vary very much from year to year, and which may have been having bad years during the particular pre-war period taken as standard. In this case the ideal solution would be for an appeal tribunal to have the right to fix a different standard period, preferably a longer period which would include some good peace-time years as well as the bad ones.[1] The other case is that of new firms which had come into existence before the war started, but had not had time to work up to their full normal profitability. If the same sort of solution were applied to this case, the appeal tribunal would have to fix the normal profit to which they considered the particular firm to be tending, a decidedly difficult thing for such a tribunal to do. The solution which has actually been adopted nearly everywhere is different.

The case of the new firm, started a year or two before the outbreak of war, so that it has declared some pre-war profits, has been assimilated to that of the new firm, started only just before the tax came into force or even later. All these cases have been taxed by a percentage standard on the high profits principle. It seems almost inevitable, even with an essentially war profits tax, to revert to the high profits principle in hard cases. Within limits this is not very dangerous.

The use of a percentage standard for the taxation of new firms does not involve much danger of the inequity which we have seen to occur when there is a general use of the high profits principle. There is not likely to have been much opportunity for a radical revision of the prospects of such firms before the war started, nor for any widespread exchange of shares on the basis of such revised prospects. The only difficulty which does arise is different. Since there are great differences in the degrees of risk attaching to investment in different sorts of enterprise, the application of the same standard rate of profit to different concerns may give a basis (from which the excess is to be measured) which is higher than the true normal profit in some cases, lower than the true normal in others. It is, therefore, a considerable improvement

[1] For the arrangements in the British E.P.D. (1915) see below, p. 73, and in E.P.T., pp. 96–7, 109.

if the standard percentage has a certain limited amount of flexibility, so that some attention can be paid to these differences in risk when fixing the standard.[1] A percentage standard used for this purpose in this way is quite unobjectionable.

When a percentage standard is used to meet hard cases among old firms, as well as among new firms, it becomes distinctly harder to prevent the occurrence of those abuses which we detected in the pure high profits tax. The particular case where some concession is admissible on the pure war profits principle is, as we have seen, that in which profits were abnormally low in the pre-war period but were expected to recover. However, it is not necessary to have recourse to a percentage standard in order to deal with this case. The reason why the percentage standard has been so commonly employed to deal with hard cases among old firms, as among new firms, is because a concession to firms with fluctuating profits does not go far enough to meet all the claims for special treatment which are in fact made. It does nothing to meet the case of declining industries.

How far do the special circumstances of a declining industry warrant special treatment? If we stick to the principle of a war profits tax, it cannot be said that they do. Such an industry may have earned good profits in the past, but it has become more or less adjusted to a lower level of profit, and if the war restores for a time its old prosperity, the extra profits which accrue are pure windfalls. If these profits are excused from the tax, or even if the tax charged upon them is appreciably alleviated, the advantage which accrues to those who have maintained their capital in the industry through thick and thin will also accrue to people who have bought up shares in it since the decline started—people who bought their shares at bargain prices, and who, even at the low pre-war level, were presumably getting more or less the return on their capital which they expected to get. In other words, the general defect of a high profits tax cuts both ways. If all firms are taxed on the high profits principle (as in the American tax of 1917), some people will be exposed to the tax who are only getting a normal return on the capital which they themselves have invested, and some people will avoid the tax who are actually getting more than a normal return. If a percentage standard is used for some

[1] For the functions of the Board of Referees in British excess profits taxes, see below, pp. 74, 93 n.

industries only, the concession which is made for the benefit of those who have stuck to the industry will also accrue to more recent investors who have really no claim to it. Obviously the importance of this consideration will be very different in different cases. It would be going too far to conclude from it that no concession ought ever to be made to declining industries, though we may conclude that no general concession ought to be made. It is much better to make special arrangements through an appeal tribunal than to permit the use of a percentage standard whenever it suits the taxpayer.[1] Each case ought to be considered on its merits.

So far we are taken by considerations of equity; but beyond that there is the general economic consideration, that a declining industry is unlikely to derive much real benefit from a purely temporary favour, which is all that it can be given within the framework of an excess profits tax. To restore its old profits for a season, and then plunge it back into adversity, may lead to much ultimately wasteful 'reconstruction'. If the special provisions in the excess profits tax are merely one stage in a considered policy of nursing the industry, then of course it is another matter. But such nursing needs very special circumstances to justify it against the charge of protectionism.

The general conclusion seems to be that an excess profits tax is a better tax the closer it keeps to the pure war profits principle, the less use it makes of the percentage standard. There are only two uses of the percentage standard which are clearly unobjectionable: one is for the case of new firms, the other is to allow for changes in capital since the standard period. If new capital has been introduced as the result of an issue of shares, it is clearly unreasonable to charge as excess profits any profits in excess of the profits of the standard period, since some of these profits will be due to the additional capital used. In such cases it is necessary to allot a standard percentage which can be earned upon the new capital before any excess profits arise; the case is exactly analogous with that of new firms, and gives rise to no difficulties of principle.[2]

[1] On this matter the provisions of the British E.P.T. (1939) are a distinct improvement upon those of E.P D. See below, pp. 97 ff, 107.

[2] The same method can properly be employed when profits have been ploughed back in the interval between the standard period and the period taxed; there is no doubt that such profits ought to be treated as an increase of capital after they have been reinvested.

Apart from these two cases, the less the percentage standard is employed the better for the consistency of the tax.

It is true that the unfairnesses, which are bound to arise out of a more extensive use of the high profits principle, are somewhat mitigated if the firm's capital is computed according to the British formula of 'capital employed' rather than the classical American formula of 'capital invested'. As we have seen, the American formula means that the capital of the firm is taken to consist of all those moneys which have been invested in the firm at any time (so far as they are ascertainable). The calculation by 'capital employed' means that the fixed capital assets employed in the business are valued at their original cost (written down for wear-and-tear according to the usual principles). The calculation thus goes back not to the original investment of money in the firm, but to the dates of acquisition of the existing plant and equipment. This gives less relevant time for changes in the ownership of shares to have taken place; but there is still a good deal of time, so that the defect in the percentage standard is by no means completely removed.[1]

A war profits tax is a tax on windfall profits; since there is very little reason in equity for claiming that anyone has the right to such profits in war-time, the special taxation of these profits can give little justifiable cause for complaint. But as soon as any element of the high profits principle is included, the tax becomes to that extent a general profits tax, a general profits tax which discriminates between firms according to the degree of profitability. The fundamental fallacy in the high profits principle consists in its neglect of the fact that all taxation is ultimately paid by individuals, not by corporate entities, which have a purely legal individuality. Taxing company profits is a means of taxing shareholders. It is perfectly reasonable to discriminate between persons, taxing richer persons at a higher rate; but the means of doing that is the income tax. It is not reasonable to discriminate between firms, without thinking what this implies among their shareholders. It is only by sticking as closely as possible to the war profits principle that an acceptable standard of equity in excess profits taxation can be attained.

[1] The Australian excess profits tax (1940) appears to be a tax of the kind here discussed. See below, p. 175.

CHAPTER VI

EXCESS PROFITS TAXES AND EFFICIENCY

ALL taxes on profits have some adverse effect on the efficiency of production, since they diminish the incentive to take on any particular piece of business, or to make any particular effort in the search for economy. But since taxes have to be raised, and on grounds of equity it is particularly important for profits to pay their share, this general restrictive effect of taxation is usually (and properly) regarded as a minor consideration. The restrictive effect of *excess* profits taxes is, however, more considerable.[1] An excess profits tax is particularly likely to damage efficiency just because it falls with its main force upon extra profits—on the profits about which the business man thinks twice, whether it is worth while making the effort, or taking the risk, necessary to earn them. In the language of economics, an excess profits tax falls directly on the *margin*; while an ordinary profits tax (such as the income tax itself) raises a great deal of revenue which has no restrictive effect, and only part of it falls upon the margin of enterprise, an excess profits tax is specially likely to fall upon the margin, where it will do most damage. Thus the effects of excess profits taxation upon efficiency need very special consideration; all the various ways which are open for moderating these uneconomic repercussions need to be carefully worked through.

The extra effort which is involved in the taking-on of an extra piece of business is perhaps most important as a deterrent for the private firm, which is actually administered by its owner or owners; but even in the case of the joint stock company, the fact that any additional piece of enterprise involves exposing capital to an additional risk remains as a deterrent which needs to be counterbalanced by some positive incentive if it is to be overcome. In war-time, patriotism may take the place of the profit motive in cases where the business in question has an obvious relation to the war effort, being one of urgent national necessity; but where the national necessity is not so obvious, the business man may be torn between his duty to the State and his duty to his shareholders. Thus patriotism alone may be less effective (and less quickly

[1] The same applies to either variety of excess profits tax.

effective) than patriotism combined with some financial inducement. As we saw when looking at the whole field in Chapter I, there is a strong case for leaving some financial incentive open.

This is not a case against excess profits taxes in general; it is only a case for using them with some discretion. There are much stronger reasons, even in normal times, for holding that business men need some incentive to efficiency than there are for holding that they need as much incentive as they actually get; since other incentives are available in war-time, the economic incentive can be safely cut down to some extent, though it cannot be cut down by more than a limited amount without dangerous consequences. Thus excess profits taxes where the rate of tax is from 20 to 50 per cent. are innocuous as compared with taxes where the rate is 60 or 80 per cent. A 100 per cent. tax, such as was imposed by the Italians in a weak moment in 1919, and such as is now in force in Great Britain, is beyond all question very dangerous indeed.

Under a 100 per cent. excess profits tax, once a firm is well past its standard revenue, it can not only derive no financial advantage from well-planned business efforts, but also (what is more obviously serious) it can often avoid any financial loss even though its efforts are badly planned. The money which the business man is administering becomes, so far as extra expenses and extra receipts are concerned, not his own but the government's; he is suddenly converted into a Civil Servant, though he has not been trained as such; while instead of the detailed Treasury supervision usually considered necessary in the case of people who are administering public money, there is nothing but the ordinary income tax checks, designed to prevent ordinary tax evasion, to see that this money is not misused.

Even while the war is continuing, and while public opinion can be trusted to set its face against flagrant and obvious abuses, a good deal of minor waste must inevitably arise from the mere fact that business men can spend money to suit their convenience, at no cost to themselves, so long as they can establish sufficient case for reckoning it as a genuine business expense to satisfy the tax authorities. It is a nuisance, for example, to carry on with old equipment requiring frequent repairs, yet in normal conditions it will often be profitable to do so. When the profit motive is removed, such kinds of equipment as are still available in war-time may often be renewed before it is really necessary.

The most flagrant abuses due to excessive rates of excess profits tax will, of course, only appear after the war is over. After the last war, in spite of the fact that rates of tax did not usually rise beyond 80 per cent., some of the worst forms of that waste which is characteristic of an immediate post-war situation were undoubtedly due to the fact that it could be indulged in at so small a cost to the enterprise itself. A 100 per cent. tax would certainly need to be repealed the very moment the war was over, if waste were not to appear upon a monstrous scale. Almost any sort of fantastic expenditure can be justified in the name of advertisement; there would be nothing to stop every cinema proprietor putting his attendants into gold leaf at the expense of the Treasury.

The opportunities for abuse and evasion inherent in an excessively high excess profits tax are enhanced by the fact that it is a temporary tax. It is usually expected that it will be removed after the war is over; in any case, conditions of active trade do not last for ever, and a firm which is now paying the tax must expect that a time will one day come when its profits will be below standard. This means that although no action taken now can secure the acquisition of higher profits now, anything which is done in the interests of future profits stands a good chance of evading the tax. If the tax is 80 per cent. the expenditure of £100 now will only reduce the profits left over after tax by £20; thus it will be worth while paying £100 for something likely to contribute to future profits if, in the absence of the tax, it would have been worth paying £20 for it. If the tax is 100 per cent. there is no limit at all (short of the whole excess profit which would otherwise have been earned) to the amount which is worth paying for something which will contribute to profits later on.[1] Business men have the maximum incentive to postpone their profits in every conceivable way—even at the expense of a reduction in their total nominal profits over the whole period (present and future together).

Some of the more obvious ways of postponing profits may be prevented by the war-time controls; but the tendency remains an extremely dangerous one, dangerous both to the economic staying-power of the country and to the current efficiency of the war effort. From the firm's point of view, the government orders

[1] One of the most curious examples of this phenomenon is the advertisement, during war-time, of goods which the advertiser hopes to be able to supply some day, but which he is entirely unable to supply at the moment.

which it receives during war-time are a purely temporary sort of business, offering no opportunity of building up a permanent connexion. If it is not allowed to derive any profit from these government orders, it will always have an incentive to give the preference to other orders which do offer the prospect of leading to more business later; even if there is no current profit to be derived from these other orders either, they may prepare the way for future profits which will not be liable to the tax, as the government orders cannot do. This is, perhaps, the most important way in which the development of war production may be impeded by excess profits taxation; whatever may be done in the other direction by priority regulations, they are bound to be working against the grain.

Another consequence of high excess profits taxes is to diminish the resistance of employers to rises in wages. For one of the best ways of defending the prospect of future profits is to keep one's labour force together as far as possible; if higher wages are demanded, and can be granted without much cost to the employer, there is a strong incentive to concede the rise. This is the chief way in which an unduly high excess profits tax may minister to inflation.

Now it must be observed that all these evils only come about so long as firms are actually making profits which are liable to the excess profits tax, and they are only likely to get out of hand if the number of firms thus liable becomes very large. So long as the general level of prices and profits remains reasonably low (that is to say, so long as really inflationary conditions do not develop) the number of firms liable to the tax may not be unmanageable. For this reason, and also for other reasons which we shall trace out in the next chapter, excess profits taxes (which need inflation to make them big revenue producers) are at their worst in inflationary conditions.

One way, therefore, of preventing excess profits taxes from having too bad an effect on efficiency is to make other taxation sufficiently severe to prevent many excess profits arising. Other methods all involve some lightening of the burden of the tax. The simplest is not to raise the rate of tax beyond 50 or 60 per cent.; but some of the alternatives to this are worth considering.

In the first place, the standard period of a war profits tax may be chosen in such a way as to allow most firms an appreciable

expansion of profits before they become liable. Trade conditions are bound to have varied during the four or five years prior to the war; if the standard period is made up out of years with good trade fewer firms will be liable than if it is made up out of years with average trade. But since the good years are not likely to have been the same for all firms, some choice of standard period is needed if this concession is to be equitable.[1]

Secondly, excess profits below a certain minimum amount may be disregarded. There was a provision in the British E.P.D. (1915) that a certain limited sum in excess of the standard revenue was exempt from tax; similar provisions are found in most foreign taxes. They do, of course, favour small concerns more than large ones (for the large concerns the concession is too trifling to matter); no doubt this was usually the reason why they were introduced. But they have the economic advantage of preventing the economic incentive for small firms from being damaged by the tax; and they cost the Government very little. By the 'minimum standard' provisions of the British E.P.T. (1939)[2] this economic advantage is retained, and the cost to the Treasury is in principle even further reduced.

In most foreign countries, but not in Britain, the same principle has been carried further by making the whole tax a progressive one, the rate of tax rising with the amount of excess profits, or successive fractions of profit being charged at higher rates of tax. Although the case for a progressive excess profits tax is much weaker than that for a progressive income tax (the higher excess profits do not necessarily go to richer people), there is nevertheless something to be said for progression on the ground that it limits the number of firms who will be paying the highest rates of tax on their marginal profits. On the other hand, this economic advantage is only secured at great sacrifice to the Treasury. Whether a progressive excess profits tax will on balance diminish efficiency less than a flat-rate tax yielding the same revenue depends upon the degree of inequality in the distribution of excess profits among firms. In practice it would appear to be very doubtful. In any case the problem only arises if the flat-rate with which the comparison is to be made is a fairly low one.

[1] The excess profits tax now imposed in New Zealand (see below, p. 177) is remarkable for its extremely generous standard period.

[2] See below, p. 95.

Progressive excess profits taxes are always likely to break down as inflation develops. With the rise in the general level of profitability, more and more firms become liable to the highest rate of tax on most of their profits. Exchequer receipts rise more rapidly than with a low flat-rate tax, but the advantageous economic effects are lost.[1] The same objection does not hold against the minimum exemption limit, since this can be more easily amended to meet new conditions.[2]

Neither of these methods (the minimum exemption limit nor the progressive tax) can do much to maintain efficiency in those firms which are earning a considerable amount of excess profits; but we have already become acquainted with another way, involving a more serious change of principle, which is more promising for this purpose. The immediate economic purpose of collecting revenue in war-time is to cut down private spending, whether by private persons or by firms. This purpose can be achieved just as well by compulsory saving or forced loan as by taxation; while the former method has the advantage of leaving open some incentive to the producer, since he retains at least some contingent right to benefit from the fruits of his efforts. Though it is consistent with the immediate aim of taxation, it does, of course, leave over a financial problem to the end of the war; but the kind of debt which is created is in fact the easiest sort to deal with.[3] The kind of thing which might be feasible is embodied in a suggestion actually made by a committee of the British Ministry of Reconstruction.[4] A part of the E.P.D. due to be paid was not to be collected as revenue directly, but was to be paid into a suspense account in the joint names of the government and the taxpayer. At a later date it was to be decided how much should be taken by

[1] In most countries the system of progression adopted was that of charging successively higher rates of profit on capital at successively higher rates of tax. This is, of course, liable to all the general objections of principle against a high profits tax. It is, however, not necessary for progression to be regulated in this way; the tax can be levied at higher rates according as profits exceed the standard revenue by different percentages of the standard. Switzerland (1916) had a slight progression of this type, while Austria-Hungary, which began with a progression of this sort in 1916, subsequently amended it into the inferior form as the result of a political squabble. (Cf. van Sickle, *Direct Taxation in Austria*, pp. 51–2.)

[2] For the adjustment made in the case of E.P.D., see below, p. 80.

[3] See above, p. 26, and below, p. 287.

[4] Committee on Financial Risks attaching to the holding of trading stock (reported December 1918). For further discussion, see below, pp. 83–5.

the government in tax, and how much should be returned. We shall return to this proposal later, in connexion with the problems of excess profits taxes in inflation, out of which it actually arose. For the present it may be noted as a possible method of increasing the incentive to efficiency in war-time; and in particular of diminishing the tendency to postpone profits (because some part of extra current profits may still become available in the future) which we have seen to be so dangerous. There are other things to be said in its favour; it may well have a real part to play in a rational scheme of war finance.

There is some analogy between this proposal and the schemes for 'blocking' profits which have been fairly common in other countries. During the last war Germany (1916) and Switzerland (1916) blocked excess profits, but mainly as a temporary measure to prevent capital flight while the machinery for tax collection was being set up, and to secure that sufficient funds to pay the tax would be available when it came to be collected. More interesting are the measures for limitation of dividends introduced in Germany (1934) and Italy (1935).[1] Although much advertised, these do not seem to have been remarkably successful; the Italian blocking was quickly converted into a progressive tax on dividends (1936). The simple limitation to a certain rate of dividend made these measures liable to the ordinary disadvantages of a high profits tax; besides, they appear to have been in general much too drastic to be readily acceptable in the conditions in which they were introduced. In each case further amendment has tended to soften down the original provisions. The ill success of these experiments is more of a reflection upon the high profits principle than upon the idea of blocking; there is no reason why blocking, if more carefully conceived and more equitably administered, should not have a better fate.

Another aspect of excess profits legislation which has a very important bearing upon the efficiency of production is the provision made for dealing with the introduction of new capital, and for demarcation of precisely what capital shall be taken to be employed in the business. It seems to be the practice of nearly all countries[2] to exclude borrowed capital from the capital employed, and correspondingly to deduct the interest on such

[1] See below, pp. 143–4, 160. [2] See however below, p. 134.

capital from the profits upon which the tax is levied. Additional capital raised by borrowing is therefore not regarded as conferring the right to any increase of standard revenue (as additional capital raised by an issue of ordinary shares would be); it is supposed to be looked after sufficiently by the deduction of the interest. There is, however, a third way in which new capital may be introduced into production: a firm may sell investments which it has been holding as reserves, and use the proceeds to increase its material equipment. There have been considerable differences between the attitudes taken by different countries about the place of such investments in excess profits tax. British practice has until lately excluded from the computation of capital all reserves not actively employed in the main business—though exceptions have had to be made for some special trades where such reserves have a peculiar importance (such as insurance and banking). In the American tax of 1917, investments were included in capital—excepting investments in concerns which were already paying income tax, this exception being obviously made so as to avoid double taxation. Other countries have only included investments in government securities. Few of these decisions seem to have been made for very profound reasons.[1] Yet in fact the way in which these questions are decided is a matter of very great economic importance, particularly when the rate of tax approaches or reaches 100 per cent.

Economically, it would appear that there are two clear-cut conceptions of profits upon which a logical tax might be based. On the one hand, profits might be taken to be those which are earned in a particular producing unit from the capital employed in that unit. This would include profits derived from the use of debentures as well as those derived from the use of share capital. Thus, while income from investments would be excluded, interest on borrowed money would not be deducted. On the other hand, taxable profits might be taken to be those which are earned by a particular financial unit, the capital owned by a given group of proprietors and jointly administered. On this definition the interest on borrowed money would be deducted, but income from invest-

[1] The British Treasury was always doubtful about its decision in the case of borrowed money (the policy of 1915 and 1939 was reversed in 1941). Stamp (*Taxation during the War*, p. 154) defended the decision, but partly on the historical ground that 'this capital feature . . . became subsequently of far greater importance than had been anticipated'.

ments would be included. The British practice, which deducts the interest on borrowed money and excludes income from investments, uses a double criterion, deducting the one because it does not accrue to the shareholders and excluding the other because it does not arise within the business. The two provisions are of opposite character and have opposite effects.[1]

Let us begin with the case of investments and consider the economic effects of excluding investment income. If a firm sells investments and uses the proceeds for extending its business, its standard revenue will then be raised by a statutory percentage on the transferred capital. The additional tax it will have to pay will depend on the difference between the additional earnings within the business and this statutory percentage. Suppose that the statutory percentage is 8 per cent., and that the yield of new capital employed in the business (made available by selling securities) is 12 per cent. Then the additional excess profits are 4 per cent. on the capital transferred; with a 50 per cent. excess profits tax, half of this would be taken away, leaving a net yield of 10 per cent. after tax. With a 100 per cent. excess profits tax, the whole 4 per cent. would be taken away, leaving a net yield of 8 per cent.—the statutory percentage. With a 100 per cent. excess profits tax, the net yield of capital introduced into the business in this way is always equal to the statutory percentage. As soon as a firm becomes liable to excess profits tax at 100 per cent., the question whether it will be profitable to transfer capital is determined solely by comparing the yield of the investments which are to be sold, with the statutory percentage.

This remains true, however little the capital is expected to yield after it has been transferred. Suppose that a firm has a standard revenue of £10,000 and is actually earning £12,000, so that it is paying £2,000 in tax. If it disposes of investments to the value of £10,000, using the proceeds to increase its stocks of materials, its standard revenue will be increased by £800 (assuming the statutory percentage to be 8 per cent.). Even if there is no additional profit earned as a result of the increase in stocks, the transaction may still be advantageous. For the amount of tax which has to be paid will be reduced from £2,000 to £1,200; instead of earning its old standard revenue (£10,000) plus the

[1] In practice, they are often set off against one another in the capital computation—not very logically.

yield of the investment (say £500), it earns the new standard revenue of £10,800. The loss which is due to the unprofitability of the new capital is borne by the Government.

The particular form which leakage of this sort is most likely to take is the piling-up of idle stocks. It will not pay to install new fixed equipment, whose life may extend beyond the probable duration of the tax, unless it has a satisfactory promise of being genuinely profitable; for although some advantage might accrue from the installation in the present, it would be balanced by probable losses in the future. But stocks of materials need not be retained for more than a limited time; so long as the stocks can be disposed of before the tax is taken off, it will be more profitable to hold reserves in the form of such idle stocks than in the form of securities yielding less than the statutory percentage.

It appears at first sight as if this danger is not so much a necessary consequence of excluding income from investments from taxable profits as a consequence of fixing the statutory percentage at too high a level. If the statutory percentage on capital introduced by selling investments is kept down to a level not higher than the ordinary yield on industrial securities, then it is true that the loophole would be considerably narrowed. But even a statutory percentage of 5 per cent. would not suffice to prevent unnecessary sales of government securities when the rate of interest on government securities is only 3 or 3½ per cent. One must conclude that a government which has imposed a 100 per cent. excess profits tax will ultimately be driven to include income from government securities in taxable profits—merely for its own protection.

Now consider the consequences of including investment income. If this is done, the mere transference of capital from one use to another will make no difference to the capital reckoned as employed, and hence no difference to the standard revenue; the taxable excess profit will rise by the difference between the yield of the new capital employed in the productive department and the yield of the investments which have been sold. As the tax approaches 100 per cent., the net financial advantage of transferring capital into production approaches nil. There will no longer be any advantage to be got from building up unnecessary stocks—and that is clearly a good thing; but there will also be no advantage to be gained from those forms of expansion which are useful for war purposes. If nothing is to be gained from holding capital in

a productive form, firms will probably prefer to hold it in the form of securities, which are a more liquid reserve; the inclusion of income from investments must therefore tend to encourage the holding of capital in liquid forms, and so to interpose a certain obstacle both against those forms of expansion which need to be discouraged and against those which need to be encouraged for war purposes.

Looking at the whole question of investment income, the conclusion seems to be that there is a decisively good case for the inclusion of income from government securities in taxable profits, but not for the inclusion of income from other investments.[1] In their case, the abuses which may result from exclusion can be largely met by adjustment of the statutory percentage; if the statutory percentage is properly adjusted, the resulting arrangement is more flexible than that which would result from inclusion.

The effect of deducting the interest on borrowed money from taxable profits is closely similar to that of *including* investment income. If loan capital is excluded from the computation of capital, and the interest on loan capital is deducted from taxable profits, there will be no adjustment of the standard revenue as the result of any money being borrowed; the whole difference between the yield of such borrowed capital employed in the business, and the interest which has to be paid on it, is liable to tax. As the tax approaches 100 per cent., a situation is reached in which no firm liable to excess profits tax has any incentive to borrow at all, excepting in so far as it can hope to get some advantage from the capital so raised at a future date when the tax will have been removed. And a firm does require some incentive if it is to borrow; an increase in debt is a burden, which must be expected to cause difficulties in the future, even if for the moment sufficient funds to meet the interest on the loan are made available.[2]

Legislation which has the general effect of restricting the incentive to borrow in war-time has a great deal to be said for it; in this part of its working an excess profits tax is a useful weapon against inflationary tendencies. Nevertheless, it falls on the just and the unjust alike; if it is a good thing for ordinary borrowing to be

[1] Most of the income from industrial investments ought to be excluded, not only on this economic ground, but also on the ground of avoiding double taxation.

[2] It should be observed that the deduction of interest means that if a firm does borrow, it costs no more to borrow at 10 per cent. than at 5 per cent., so long as the 100 per cent. tax remains in existence.

restricted, the restriction of borrowing by businesses which are directly engaged in the war effort is not at all a good thing. It is inevitable that special measures should be taken to counteract this. The principal device usually employed to ensure that the expansion of direct war industry is not unduly hampered by excess profits taxation is that of special amortization:[1] equipment which has been installed for purposes of war production and is not likely to be of much use after the war is allowed to be written down at a specially rapid rate before any taxable profits are declared. Some device of this sort is bound to be necessary in any case; the gross profits derived from the operation of special war equipment are bound to be regarded as being mainly repayments of capital, so that firms would certainly be involved in losses as a result of installing it, if these profits were even moderately taxed. If the rate of tax is high, and loan capital is excluded from computation, the need for very generous measures of this sort becomes particularly pressing; businesses cannot be expected to make great extensions of plant and to forgo the prospect of deriving profits from them, unless they are given a complete guarantee against being involved in losses as a result of the actions they have been persuaded to take. When the rate of tax is 100 per cent., it becomes very doubtful whether any special amortization provisions can be a sufficient guarantee. Confiscation of excess profits is bound to hold up the expansion of war industry unless the government is prepared to finance almost all the necessary extensions of plant out of public funds.[2] That is what it will be obliged to do, yet it cannot be said that such a method of finance has much prospect of being economical. No one intimately concerned will have much incentive to keep down costs; and since the firm whose equipment is being extended can usually look forward to acquiring the new plant on very favourable terms when the war is over (for it will be worth more to that firm than to anyone else), the whole procedure may not in fact involve such complete confiscation of profits after all.

[1] For the British provisions, see below, pp. 77–8 and 98; for the American, pp. 127 and 134. It has been reported in the Press that the excess profits legislation introduced in Sweden during 1940 actually exempts from tax aircraft and some other munition manufacturers. This is the direct opposite to the sort of policy usually adopted in other countries, but it is, of course, infinitely more sensible on economic grounds. Unfortunately we have no detailed information.

[2] For the British experience, see below, p. 103.

CHAPTER VII

EXCESS PROFITS TAXES UNDER INFLATION

We have noticed four ways in which the imposition of excess profits taxes may have some influence upon the progress of war inflation. In the first place, an excess profits tax, like any other direct tax, has some tendency to reduce private spending, because it reduces disposable incomes. In the second place, it tends to reduce business expenditure out of undistributed profits. In the third place, if the rate of tax is high it has some tendency to check business borrowing. All these tendencies act as brakes on the inflationary process. The only thing which has to be set on the other side is the fact that most of the forms of evasion and semi-evasion which we have been discussing tend to increase business expenditure.

So long as the war continues without any end being in sight, the only form of evasion which seems likely to affect the rate of inflation to any appreciable extent is the incentive to employers to withdraw opposition to advances in wages. The only influence in the other direction which seems likely to be of much importance is the check to spending out of undistributed profits. The check to private spending due to an excess profits tax is much less than that due to most other forms of taxation. Even in the absence of tax, excess profits made in war-time are much less likely to be distributed than ordinary profits; in view of their probable temporariness, they would very often be placed to reserve within the firm. But the fact that they were placed to reserve does not mean that they would not be spent; it is the check which it imposes on spending out of profits for business purposes which is perhaps the most useful economic function of an excess profits tax.

Evasion of the tax by increasing business expenditure is therefore to be deplored, economically as well as fiscally; but it seems unlikely that it will develop to its full extent until the last stages of a war. Passive evasion, in the forms of diminished resistance to rising costs, and general carelessness, is dangerous at all stages; active evasion, in the form of building up assets likely to be useful in the future, will not develop fully until there is positive confidence in a future worth planning for. This is therefore in the main an end-of-war problem. As the war draws to an end, and

in the immediate post-war situation, evasion must be expected to be on such a scale that it will be practically impossible to maintain an excess profits tax at confiscatory rates for any length of time; even an 80 per cent. tax may be too high to prevent conspicuous waste, which is yet of such a character that it will be hard for the revenue authorities to disallow it.

Nevertheless, a time when private spending is on the increase, and when business activity is still expanding in an inflationary manner, is not a time when reductions in taxation are themselves desirable. Indeed it would paradoxically appear that in spite of the increased evasion this is precisely the stage when an excess profits tax will be doing its work as a curb on spending most efficiently. For this, far more than during the war, is a time when there is a danger of a great and disorderly increase in business spending—business spending on the renewal of equipment. Such renewal has become urgently necessary, but it is most desirable that it should proceed in an orderly manner; excessive haste over the renewals which are necessary for the restarting of peace-time industry is the main cause of post-war boom. Thus it would clearly be uneconomic to repeal the excess profits tax at this stage, putting nothing in its place. What is needed is some adjustment in the form of the tax to meet the new conditions, not yet a simple repeal.

Altogether, the problem of how to bring an excess profits tax to an end is not the least of the problems connected with the tax. A tax on war profits has got to be brought to an end sooner or later; but it is very difficult to bring it to an end without the elapse of some time during which its approaching demise is anticipated, and therefore the incentive to evasion by postponing profits is at its maximum.

Some difficulty in the winding-up of the tax is bound to arise whether or not there has been any serious degree of war inflation; if inflation does occur, there are other difficulties in the working of the tax, to which we must now turn our attention. We have already seen[1] that inflationary profits, although they may be high in terms of money and therefore liable to excess profits taxation, may not be at all high in real terms, because their real value is cut down by high prices. When inflation has proceeded at all far, an excess profits tax ceases to be a tax upon those who are doing well

[1] See above, p. 9.

out of the war; it approximates more and more to the shape of a simple tax on profits generally. In this there is perhaps no particular harm; what is a great deal more serious is that the 'profits' calculated by ordinary accounting processes are swollen under inflation by sums which, economically considered, are capital rather than income. An excess profits tax begins to acquire some of the characteristics of a capital levy, a rather bad sort of capital levy. There may be a good case for a capital levy on individuals as a means of paying for the war (we shall discuss that later in this book); the levy here in question is a levy on businesses, which is less defensible. Let us see how it happens.

All accounting methods calculate the profit which is earned on any particular article produced on the principle of subtracting from the selling price received for it the costs which have been incurred in producing it. These costs may have been incurred at various dates in the past, perhaps not in the very recent past; but that is not allowed to affect the principle. Thus under conditions of inflation, the fact that prices in general are higher at the time of sale than they were when some at least of the costs were incurred automatically swells the profits so calculated. 'Profits' rise, not in proportion to the rise in prices, but more than in proportion; because they are calculated as a difference between selling prices (measured at one level of prices) and costs (measured at a lower level). Yet it is directly evident that profits calculated in this way do not really measure the net gain out of industry; for if all these 'profits' were distributed as dividends, or collected as taxes, the scale on which business was conducted would be obliged continually to contract—or rather, it could only be maintained by a series of new borrowings. Whatever the rate at which working capital was turned over, a business which was trying to keep clear of new borrowing would find that the distribution of all the 'profits' so earned would leave it with an unchanged volume of working capital in terms of money; and this would be insufficient, at higher prices, to conduct the same volume of business as before, that is to say, to maintain the same output. Further, since the depreciation of fixed capital is generally calculated upon the same principles (the sums set aside for depreciation depending upon the original cost of acquiring the fixed assets), it would be impossible to replace these assets out of the usual depreciation funds when the prices of fixed equipment had risen. There would thus be a

difficulty about the maintenance of fixed capital as well as of working capital.

For these reasons, it will undoubtedly be wise policy for a business not to distribute, during a period of inflation, all (or anything like all) of the profits which its accountants declare it to have made. A large part of these profits ought, from the firm's own point of view, to be placed to reserve. If it is endeavouring to maintain the same output as before the inflation began, it will need this reserve for the current conduct of its business; if (as will often happen during a war) it is in any case obliged to restrict the scale of its operations for the time being, it will still have to think of the day when it will want to return to normal activity. At that time it may be hardly possible to proceed without raising fresh capital; but the larger the reserves which can be built up against that day, the easier will the necessary new capital be to raise.

Heavy excess profits taxes make it very difficult, if not impossible, to build up such reserves. Remembering that the war has to be paid for in some way, and that this is a possible way of paying for it, let us consider whether or not it is a good way.

A numerical illustration will help to fix our ideas. Suppose that the result of the war has been to double the general level of prices, and that all the profits (in the accountant's sense) which have accrued during the war have been liable to a 100 per cent. excess profits tax. Then (apart from any new capital which may have been introduced from outside), even a successful firm will find itself at the end of the war with more or less the same money value of working capital as it had at the beginning; and with a fixed equipment which would have doubled in money value if it had been in the same condition as it was at the beginning, but which is actually not in the same condition, having been worn down to some extent during the war, without sufficient sums having been set aside in wear-and-tear allowances to cover the cost of restoring it to its original condition at the new level of prices. Thus if the firm began with £100,000 of working capital and £100,000 of fixed capital, it may be expected to end with (say) £120,000 of working capital and £180,000 of fixed (all valued at the new prices);[1]

[1] We have allowed for some expansion in the money value of working capital on account of the possibility that with certain methods of stock valuation some part of the firm's stock of materials might retain its value through the war in the same sort of way as its fixed capital would do. If the cost of the materials used for the production of any particular unit of product is estimated by taking

this would be a generous estimate. But in view of the rise in prices, double the money value of the pre-war capital would be required to produce the pre-war output—that is to say, £400,000 against an actual £300,000. If the pre-war output were to be maintained, £100,000 of new capital would have to be raised.

The result of this would be that even when the excess profits tax was removed, the original proprietors of the business would still not find themselves with profits which had risen by anything like as much as the cost of living would have risen. The total profits of the concern might have doubled in terms of money; but this would only happen if new capital had been introduced, so that these profits (doubled in money, but constant in real terms) would have to be shared with the people providing the new capital. The original proprietors would still have to make a sacrifice—a permanent sacrifice.

It is, however, possible that the ordinary shareholders of the concern might escape from this loss if a sufficient amount of the original capital had been raised by fixed-interest obligations (loans, debentures, or preference shares). The sums needed to meet these obligations would be constant in money terms, reduced in real terms; so that if, in our example, half the original capital had been raised in these ways, the ordinary shareholders would find that their profits would be more or less doubled. Even when the higher cost of living is allowed for, they would still be no worse off than before the war. The sacrifice would be pushed off on to the creditors and debenture-holders.

In view of this last consideration, there is not much to be said for preventing an excess profits tax from eating into the capital of firms just because prices have risen. If any special measures were taken for this purpose, they would clearly redound to the advantage

the average cost of the materials of that sort possessed by the firm at the time of utilization, this expansion will not occur, our previous argument holds precisely. But if the accounting is performed upon what is called the 'last in, first out' principle, so that the cost is taken as that of the materials most recently acquired, it does become possible for a certain stock of materials to be carried through the war without any profits ever being declared on the rise in its value. But all that can possibly escape in this way is the minimum amount below which the stock never falls at any time during the war; it is only this stock which will be kept on one side and never brought into the profit reckoning. It is not likely that it will often represent a large proportion of total working capital; and it is only if the second method of stock valuation is followed that even this reserve stock will escape.

of ordinary shareholders, who are in any case made relatively better off by the inflationary process. As we shall see later on, the case is very different if the rise in prices proves to be no more than temporary, if the rise in prices is followed by a fall. In that case the ordinary shareholder loses his advantage, and the case in equity against doing anything which might assist him loses most of its force. But before we come to that there is another consequence of the rising phase which needs to be considered.

The new capital, which almost all firms will be obliged to raise as a result of the process we have described, is bound to take a different form in different sorts of firms. What form it takes is a matter of some importance, since if the new capital has to be raised by borrowing, the position of the concern will be rendered less liquid, and it will be more liable to be upset by such depressions of trade as may occur in the future—depressions which may or may not have anything to do with the war in question. Let us consider three typical cases.

A, a large public company, was rather 'high-geared' at the commencement of the war; fixed-interest obligations swallowed the major part of its profits. As a result of the inflation, it will find itself considerably less burdened with loan charges than before; consequently it will be able to offer very favourable terms to new subscribers. If it succeeds in making a new issue of ordinary shares, its position will be actually stronger than it was before the war began; even if the market is not in sufficiently good condition for this to be practicable, so that the new issue has to take the form of fixed-interest securities, it will only be reverting to its former position. B, on the other hand, a company which had been fairly free of fixed-interest charges, will not find that its position with respect to the capital market has improved in this way. If it is lucky, it may be able to float a new issue of ordinary shares; but with a flood of new issues forthcoming, it is fairly certain that some B's will not be so lucky. Starting from a strong position, they will find that strong position weakened. But their position is nothing like so serious as that of the small private concern, C, which has in any case very restricted access to the capital market. C may have no alternative but to restrict the scale of its operations, or perhaps to rely upon loans from the bank. Neither a restriction of the activities of small businesses, nor their increased dependence upon the banks, is a healthy development. It is a fortunate thing

that most excess profits legislation is fairly tender towards the small business; we now see that there is a very substantial reason why it should be so.

Apart from the desirability of easing the position of the small business, there is not much case for special measures to assist in re-financing, *so long as it is assumed that prices will remain at the high level*; if the excess profits tax had been less drastic, the re-financing problem might have been less acute, but there is nothing much to be done about the specific problem of inflation and capital structure which is at all consistent with equity. But there is always the possibility of a fall in prices after the restoration of peace; that would create a very different situation.

Let us revert for a moment to our case of the firm which started the war with a capital of £200,000 and finished it with a capital worth £300,000, prices being then twice as high. If, in the next phase, prices reverted to their pre-war level, the firm's capital would only be worth £150,000. Allowing for the slackness of trade, and the working below capacity, which would be the almost inevitable consequences of such a fall in prices, it is evident that bankruptcy might not be far distant. It was this peril, rather than those which we have been discussing, which concentrated attention upon the relation between inflation and E.P.D. in the latter stages of the last war.[1] The rise in prices was leading to an artificial expansion of profits in the way we have described; with an 80 per cent. E.P.D., the greater part of these additional profits was annexed by the State. The lag in collection of the tax was at first sufficient to ensure that business men did not find themselves seriously short of capital for replacing their stocks (the tax assessed on 1917 profits was not collected until 1918 or later, when prices had risen still further and the old tax could therefore be met fairly easily); but there was a good deal of foreboding about what might happen later on. It was universally considered that the great rise in prices during the war was a purely temporary rise; sooner or later prices would come back to their pre-war level. And then, so it was held, the experience of the upswing would be reversed; deflationary losses would match the inflationary gains. The business man felt that he ought to be adding to his reserves during the upswing, not so much in order to diminish the need for re-financing

[1] See the Report of the Ministry of Reconstruction Committee, previously referred to (p. 48). Also below, pp. 82–5.

as in order that he should have a reserve to meet the fall in prices which he expected to take place at a later date. But whichever way it was looked at, the confiscation by the government of the sums which ought to have been going to reserve was felt as a hardship, and as a hardship which had not been envisaged in the original imposition of the tax.

It is very instructive to observe what did actually happen after the war was over, not in Great Britain only but in other countries as well. In no case was the fall in prices (1920–2) as great as had been anticipated; prices did not return to the pre-war level. In America the post-war deflation was hardly worse than an ordinary trade slump;[1] with most of the continental ex-belligerents it was speedily cancelled out by renewed inflation. In these cases the problem did not really come up; there were only two cases where it did come up quite clearly. These were Britain and Italy, in both of which countries there was a great fall in prices, after which a new normal level was established, much above the pre-war level, but also much below that which had been reached in the meantime. The excess profits legislation was not dissimilar. When the profits of inflation were succeeded by the losses of deflation, the reserves which ought to have gone to cover those losses had been collected by the State, or were earmarked against taxation due but not yet collected. The stage was set in the same way in the two countries, yet the denouement was totally different.

In each case the revenue authorities had to make concessions, but the concessions were made at different stages. The Italians began by taking a firm line and trying to enforce the tax according to its original principles; at the same time the rate of tax was put up to 100 per cent. under pressure from the Left; the burden upon business became utterly crushing. Rigorous enforcement only resulted in wholesale 'fiscal bankruptcies'.[2] This could not go on; it was indeed only one aspect of the general breakdown of democracy in Italy; as the political wind changed, one alleviation followed another, until most of the outstanding claims against business capital had been written off. The attempt to secure social justice by stopping the activity of industry had made Fascism inevitable.

In Britain, by contrast, concessions were made much earlier; the question rather is whether they were not too generous. From

[1] See below, p. 132.

[2] See below, pp. 161–4.

the earliest days of the tax it had been conceded that if a firm, after becoming liable to E.P.D. in one year, earned less than its standard revenue in a subsequent year, it could set this 'deficiency' against the tax to which it had become liable; in effect the whole period of duty (1915–21) was taken together, and a firm was only liable on the excess over its standard revenue earned during the whole period. In the discussions which had taken place in 1917–18, it was no doubt not expected, either by the government representatives or by the representatives of industry, that the tax would continue in existence long enough for this deficiency provision to become a matter of the first importance; consequently various minor concessions were made with the object of softening the expected blow from falling prices. Yet the greatest concession of all was unintentional; after the rate of tax had been lowered to 40 per cent. in 1919, it was raised again to 60 per cent. in 1920; but this latter increase, instead of giving the State a share in boom profits as had been its intention, operated almost entirely to the advantage of the taxpayer. Hundreds of millions of pounds, which would have been due to the Government if the tax had been repealed in 1920, had to be repaid to industry, as a result of keeping on the 'tax' at war rates right into the slump year 1921. So the inflationary profits had not been so completely confiscated after all; they were merely held in safe keeping (a very good place for them) until they were wanted; the story (at least so far as industry was concerned) had a reasonably happy ending.

From the point of view of future policy, it is important to realize that this happy ending was an accident; it had certainly not been planned to fall out that way, and it was not at all a happy ending for the Treasury, the cost being enormous. Yet in broad lines what was done was the right thing to do; impounding profits during the war and the post-war boom was a useful means of checking inflation; releasing them (or a part of them) during the subsequent slump prevented the slump from getting too much out of hand. If the tax had been brought to an end a year earlier, it might (at first sight) have been better for the Treasury; but the Italian example is an object-lesson of what might have happened then. The outstanding arrears would have been impossible to collect, while at the same time the enormous obligations to the State would have been a powerful factor depressing business activity until they were written off (nothing is so likely to breed unemployment as the

maintenance of a large number of firms in a state of semi-bankruptcy); to write off the arrears of those firms which had not paid would be monstrously unfair to those which had paid up. In spite of the considerable nuisance of the arrears which did in fact hang on many years after the tax was repealed, we may say that England was extremely fortunate in avoiding far worse consequences of the tax than those actually encountered.

It would be foolish to expect such luck to occur again; if these dangerous consequences are to be avoided on another occasion positive steps will have to be taken to prevent them. The mere inclusion of provisions for deficiency payments is not sufficient, since the Treasury can be relied upon to do its utmost to prevent the period of tax being prolonged so far that there is a danger of large claims for deficiencies arising. Nor is it reasonable, on the other hand, for the Treasury to be asked to undertake unlimited commitments for deficiencies, such as would be involved if a pledge were given (it could not be a very definite pledge) not to repeal the tax until 'normal' conditions were restored. What is needed is for some part of the receipts from excess profits taxation to be held as blocked savings, rather than confiscated outright. From the point of view of post-war reconstruction, as from the point of view of war-time efficiency, some introduction of the principle of compulsory saving considerably diminishes the economic dangers of a high excess profits tax.[1]

The dangers which we have been considering in this chapter are entirely due to the fact that excess profits taxes fall upon profits, on the profits earned by business capital, not on the incomes of the people who own that capital. If the taxation were to be levied upon the incomes of individuals, instead of on the profits of businesses, these dangers would be avoided. Thus it is now time for us to turn back to the excess income tax.

[1] For more detailed discussion see below, pp. 113, 117 a.

CHAPTER VIII

THE CASE FOR A SUPPLEMENTARY EXCESS INCOME TAX

ALTHOUGH a personal excess income tax cannot be used as the only method of war-wealth taxation (because of the loophole which would be left for amassing profits in reserve funds and only distributing them after the war),[1] there may still be a good case for imposing it as a supplementary measure. This is, in fact the way in which excess income taxes have generally been imposed. There seems to be no recorded instance of a country endeavouring to rely upon an excess income tax without an excess profits tax; but supplementary excess income taxes are quite a common phenomenon.[2] Assuming that the administrative difficulties of an excess income tax can be overcome (the experience of some countries with inefficient or unsuitable tax administrations is no argument to the contrary), would the imposition of such a tax be a good thing? The matter seems to have two aspects.

First of all, seeing that an excess income tax is, in principle, a more equitable sort of tax than an excess profits tax, and that there are certain forms of war wealth which escape from an excess profits tax, what is the case for using an excess income tax as an additional source of revenue? Taking a particular system of excess profits taxation for granted, is it desirable to superimpose an excess income tax upon it? That is the first question; the second arises out of the very considerable economic dangers which we have found to be involved when an excess profits tax is levied at high or confiscatory rates. To seek to avoid these dangers by abandoning the excess profits tax in favour of an excess income tax would only make matters worse. But what is the case for a partial substitution, introducing an excess income tax at high rates combined with an excess profits tax at rather lower rates instead of the excess profits tax at such high rates? These are the two questions we have to discuss. Let us begin with the use of the excess income tax as a means of widening the scope of war-wealth taxation.

[1] See above, p. 32.

[2] All the excess profits taxes in Scandinavia (1915–18), those in Germany (1916 and 1939), Austria-Hungary (1917), Netherlands (1916), and America (for the single year 1917) contained an excess income tax supplement.

One of the arguments most frequently put forward in support of an excess income tax is that it might be used as a means of limiting the high wages in the munition industries, or at least of limiting their cost to the State. These high wages are a form of war wealth; they would undoubtedly come within the scope of an excess income tax unless special measures were taken to exempt them. Yet, quite apart from the political difficulties, it is fairly certain that an excess income tax would prove to be disappointing in this particular application; there are two reasons why it would do a good deal less to limit the net wages paid out to workers in the war industries than might be supposed at first sight.

In the first place, it would often be very difficult to reckon as excess earnings all the increase in labour incomes which had taken place since before the war. The broad information, which is all that would be available about the pre-war earnings of a class which did not pay income tax, would hardly be sufficient to permit of the adoption of a pre-war standard period. Excess profits taxation is based upon a comparison with the pre-war profits of the actual firm which is being taxed. A tax on wages with lower standards of fairness than the corresponding tax on profits would surely be intolerable. Thus the earliest standard period which could readily be justified would be that represented by the date when the tax was imposed, since this would be the earliest date for which the required information could be collected. A considerable part of the excess might therefore fall outside the possible scope of the tax.

In the second place, the levels of workers' earnings are largely (though not entirely) determined by the standard rates (including overtime rates) negotiated by trade unions. Considering that the tax would mostly fall upon increases in wages secured after the date of imposition, it can hardly be doubted that trade unions, in formulating their demands for such wage-increases, would take the liability to tax into account, and write up their demands accordingly. (If they did not do so, it would surely mean that they were in such a reasonable frame of mind that the end of limiting wages could be more simply reached by direct negotiation.) The case is not parallel with that of an ordinary income tax on wages, which would not (if it were politically feasible) encounter any serious economic difficulty; the tax would fall mainly upon incomes already established at the time when it was imposed, and a demand for special increases in wages to compensate for the tax

burden could hardly expect to be favourably received. But excess income tax would be largely evaded in this way, unless it were made confiscatory at a 100 per cent. rate; and that would be disastrous, since some at least of the high wages of war-time are absolutely necessary in order to provide an incentive for industrial transference and for intense effort where it is most urgently needed. Besides, once the principle of paying some attention to the cost of living in fixing wages has been established, it is already conceded that wages shall be treated less drastically than profits. The idea of deriving much useful revenue (revenue that would not be cancelled out by wage-increases) from an excess income tax on wages is probably chimerical.

All the excess income taxes which have been imposed in various countries at various times seem to have allowed for this; the exemption limit[1] has been fixed high enough to exclude wage-incomes. Yet even when the spectacular application to wages is avoided, there will still be some war gains which escape from an excess profits tax, though they would be liable to an excess income tax. There are some professional people who prosper in war-time; there are accountants and lawyers who make money out of the excess profits tax itself; why should these be allowed to escape? The payment of higher salaries to managerial staffs is one of the ways by which an excess profits tax can be evaded; these salaries would be reached by an excess income tax. Even if wages were excluded, an excess income tax would bring in some extra revenue, and it would stop some of the leakages to which a pure excess profits tax is subject.

The application of an excess income tax to salaries has, however, to meet the objection that increases due, directly or indirectly, to the war would not be the only ones to be taxed, but also increases occurring in the ordinary course of promotion. There are some instances of legislation which has formally excluded 'normal increases in wages and salaries' from the scope of an excess income

[1] There are, of course, two possible sorts of exemption limit in an excess income tax—one referring to the total income of the taxpayer, one to his excess income. If, as in Germany to-day, a fairly high minimum *excess* is free of duty, wage-earners are excluded, but so are many other people whose incomes have risen as a result of the war, but risen by less than the minimum amount. It is, however, perfectly possible to exempt incomes below a certain level, but to tax incomes above that level, when the excess exceeds another (smaller) minimum.

tax;[1] but it is hard to believe that such an exclusion could be satisfactorily administered. The objection does not really appear to be a very serious one for a country which is deeply engaged in war; normal promotions will then be largely suspended in any case. Those which are not will be mostly excluded from the tax as falling under the exemption limit. There would of course be trouble if the tax were kept on after the war was over; the most important conclusion which we have to draw from this point about promotions is the absolute necessity of removing an excess income tax very soon after the end of hostilities.

If an excess profits tax at a high rate has already been levied (certainly if the rate is 100 per cent.), the extra revenue which would be got from imposing an excess income tax on the top of it would have to come in the main from salaries and professional earnings; it is hardly possible to suppose that enough would be got to cover the cost of collection. That is a fatal argument against imposing an excess income tax in such circumstances. The only serious case for an excess income tax is if it is also to be used as an alternative to such high rates of excess profits tax. Instead of taxing excess profits at a confiscatory rate, the rate of the excess profits tax might be kept at a more moderate level; but if any of the untaxed profits were distributed as extra dividends, the dividends would become liable to excess income tax provided they raised the incomes of the shareholders above their pre-war normal. The rate of excess income tax might be made very high, at least on the higher incomes; and yet there might be less danger of deleterious economic effects than with a confiscatory excess profits tax.

It is true that even with the highest rates of excess income tax, the yield to the Exchequer of this combined excess profit-and-income tax would not be so great (at least prima facie) as the yield of an excess profits tax levied at confiscatory rates. For one thing, those profits which were not distributed would escape the excess income tax; and for another, those shareholders who possessed a spread of various sorts of securities, some paying higher dividends than in peace-time, some lower, might not experience any net rise in income, so that they would not be liable to excess income tax; yet if a confiscatory excess profits tax had been levied, it would probably have prevented them from getting higher dividends on

[1] Netherlands (1916), Germany (March 1939). Neither country was at war at the time of this legislation.

any of their securities, so that their total incomes would be less than pre-war, the difference accruing to the government. Nevertheless, there are considerable economic advantages to set against these reductions in revenue. We saw in the last chapter how dangerous it is for an excess profits tax completely to prevent firms from building up reserves; some concession in this direction has a good deal to be said for it, particularly if there is a danger of inflation. We have also repeatedly seen how dangerous it is to cut down too far the economic incentive to good management; now on the plan of a moderate excess profits tax and a fairly high excess income tax the incentive to good management would be largely retained. The business man would still have an incentive to make profits in order to add to his reserves; and even beyond that, he would still have some incentive to make profits in order to distribute dividends: since although the greater part of any extra dividends would return to the government in excess income tax, some of his shareholders would be greatly benefited by a distribution of dividends which would prevent their incomes falling below their pre-war level. The profit motive would be left substantially intact as an economic incentive—at a very moderate cost to the State, or to the community in general.

It is indeed highly probable that greater moderation in the rate of tax which had to be taken into account in any single economic calculation would appreciably diminish the incentive to evasion; this would be a favourable factor from the economic point of view which would go some way towards offsetting the direct loss. And since anything which increases business efficiency and economy must operate to reduce government expenditure—the expenditure necessary to achieve given war aims—there is bound to be something on the other side to set against the loss in revenue. To look at financial problems from too narrowly a revenue point of view is a mistake in war just as much as in peace.

When all these points are considered together, it would appear that there is a good deal more to be said for a moderate excess profits tax (say 60 or 70 per cent.) combined with a drastic excess income tax (rising to 100 per cent.) than there is for a drastic excess profits tax (80–100 per cent.) taken alone. The combined tax would include more of the real war gains than a simple excess profits tax would do; it would include less of those war gains which are only apparent gains, due to the failure of accounting methods

to cope with a changing value of money. The combined tax would be less harmful to economic efficiency. The only kind of war wealth which might possibly escape from the combined tax, though it would not escape from a simple excess profits tax, is that which might be accumulated in undistributed profits. The function of the excess profits part of the combined tax would be to prevent excessive leakage in this direction. It would not prevent the leakage altogether, but it has by now become abundantly clear that to try to prevent it altogether would do more harm than good; not so much to the interests of the shareholders, as to those of the community in general, to the efficiency of the war effort, and to the prospect of preserving industrial stability after the war.

It is not probable that the effective war gains which would escape from such a combined tax would be at all considerable; if they should turn out to be considerable, the right way to deal with them is by one of the post-war measures, which we shall discuss in the latter parts of this book.

Our discussion of the principles of excess profits taxation has disclosed two main methods by which it would be possible to secure the same thorough-going control of war gains as is attempted to be secured by a confiscatory excess profits tax, while avoiding the most serious economic dangers involved in that tax. These methods are the combination with an excess income tax, which we have discussed in this chapter, and the combination with a blocking of excess profits, which we discussed previously. In putting forward these alternatives, it has of course been the present British emergency which we have had mainly in mind. But before we can proceed to discuss this application, we must examine in more detail the actual development of excess profits taxes in Great Britain.

PART III

EXCESS PROFITS TAXES IN GREAT BRITAIN

CHAPTER IX

E.P.D. (1915–21)

THE basis of British practice in the taxation of war profits is the Excess Profits Duty, imposed in the second budget of 1915 and repealed in the Finance Act of 1921. All later profits taxes, proposed or imposed, have built on its foundation. Although E.P.D. was not introduced until the war had been going on over a year, it had been under discussion since the spring of 1915, and when in October the new tax first appeared in print, its main lines were already cast in the form in which they were enacted. E.P.D. appeared to have sprung Minerva-like fully grown from its creator's head. The tax that emerged was hailed on all sides as a great success. From its start to the end of March 1921 it yielded £1,154·5 millions, or 25 per cent. of total tax revenue during the period. Although not the first tax on excess profits to be imposed,[1] its provisions were widely copied. The Americans, whose dissatisfaction with their own tax was shown by the innumerable alterations made in it on several occasions,[2] did E.P.D. the honour of a special inquiry, and us the service of producing the best account of it that has been written.[3]

It is clearly necessary for us therefore to examine carefully the details of E.P.D. in so far as they are of economic importance.[4] Its provisions and history can be made to shed much light on the working of present and future taxes. We shall find that there is also another side to the picture which has not received so much attention. The yield of E.P.D. was enormous, but it was not nearly so

[1] The British Munitions Levy and the Danish tax preceded it.

[2] See below, pp. 119–22.

[3] Haig, *The Taxation of Excess Profits in Great Britain*, *American Economic Review* Supplement, 1920 The account given by Lord Stamp in *Taxation during the War* is somewhat disappointing because written from a narrow Revenue point of view. But it is invaluable for the sidelights thrown on the form of the tax and its amendments

[4] Full details may be found in accountants' books, such as Langdon, *The Excess Profits Duty and Excess Mineral Rights Duty* (Stephens & Haynes), and Snelling, *Excess Profits Duty*, &c (Pitman).

much as it should or might have been. Apart from evasion which was known to be extensive, the profits which had become liable to tax, but on which it had not been paid, increased steadily as time went by. In 1916–17 £35 millions of tax or 25 per cent. of receipts was thus due.[1] The following year it had become £96 millions and in the summer of 1919 had reached £200 millions and was still expanding. In 1936, fifteen years after E.P.D. had been repealed, net liabilities running into millions were still being collected annually. The inequity and economic disturbance caused by tax liability being incurred and discharged at widely different periods, and consequently at widely differing values of money, hardly need emphasizing. Nor is this all. The tax was levied at varying rates which over the period averaged out at over 63 per cent. But the net receipts were never anything like this proportion of total excess profits.[2] Partly because of exemptions, but much more because of discharges and repayments, they were finally hardly more than 34 per cent. Thus while the high rates of tax exerted their full economic effect on efficiency and incentive during their currency, the final effect of the tax was less drastic than it might have been, and has consequently left a sweeter memory. But in ordinary times such a fiscal result would almost have put a tax out of court. It suggests that some at least of the provisions of E.P.D. must have been more or less unworkable.

The American inquiry, based on the facts of 1919–20, was too early for the full effects of the war difficulties to be apparent. To Lord Stamp, writing a decade later, the facts were known—but a father may be forgiven for some partiality to his offspring.

Using the distinction which has been made above,[3] E.P.D. was a hybrid Excess Profits Tax. That is to say, it was open to the taxpayer to be taxed either on the extent by which his war profit exceeded his peace profit or on the amount by which the return on his capital exceeded the statutory rate which the government considered to be a reasonable minimum.[4] Since the statutory rate

[1] Cf. Haig, op. cit., p. 115. This figure includes both arrears and assessments not yet completed. For figures of arrears see below, p. 87.

[2] Stated by Stamp to have been £3,500 millions.

[3] See above, p. 36. It was applied to all profits except those of farmers. Salaries and professional fees were outside its scope.

[4] Stamp, op. cit., p. 154, *makes it clear that no notion of abstract normality* was intended. The percentage standard was 'merely a minimum protection against hard cases—a kind of bulwark'.

(beginning at 6 per cent. for companies and 7 per cent. for private firms) was not very high in relation to pre-war profits—1912 and 1913 both being abnormally good years—in most cases firms preferred to be taxed on the change in profits. E.P.D. was thus predominantly a war profits tax.

For the purpose of determining the standard profit firms were allowed to choose the average of the two best of the three pre-war trade years. Stamp[1] reveals that originally it had not been intended to allow such a wide choice. It was a concession made in discussion. He estimates that it had the effect of raising the effective standard profit by about 15 per cent. It probably therefore put many firms who would otherwise have chosen the percentage standard on to the profits standard, and made the tax more completely a war profits tax. The full choice of years operated only for old firms. Those which had been in existence two years could, however, choose either their average profits or the profits of the second year. Only for quite new firms was the profits standard restricted to one year. But all fairly recent firms stood to benefit considerably from the allowance for capital not fully remunerative.[2] Both methods of calculating the excess assumed that there had been no change in capital since the standard was determined. When in any accounting period a change occurred an adjustment was made to the profits to allow for this.[3]

The following special concessions were included for particular hard cases. There was a minimum exemption limit (originally for excess profits up to £200), which was not too small to be a substantial benefit to small firms. Industries which normally expected fluctuating profits, but which might have been caught by the downswing in the standard years, or firms which might have been suffering temporary misfortune, were catered for by being allowed to take as their standard the four best of the six pre-war trade years, provided they could show that their profits in the three last of these had been at least 25 per cent. below the profits in the first three.[4] For capital that had been invested less than three years

[1] Op cit., p. 156. [2] See next paragraph.

[3] The profit figure was decreased by the statutory percentage where capital had been withdrawn from the business, and increased by the statutory percentage where new investment had taken place. This device had the same effect as a change in the standard revenue, but was a considerable administrative simplification.

[4] This concession was introduced in 1916

and was not fully remunerative before the war an addition to the standard revenue, equal to the statutory percentage, might be made.

In addition to these general legislative concessions further adjustment to particular circumstances was provided by means of appeals to the Board of Referees—a by-product of E.P.D. which proved a most useful addition to fiscal machinery. The Board of Referees was empowered to fix an artificially favourable standard revenue in three special cases. For capital employed on munitions work which could not be expected to be fully remunerative after the war a special profits standard might be declared; in businesses where the capital employed was small relatively to the capital normally at stake, the standard revenue might be determined by some factor other than the capital employed; and finally a special addition to the percentage standard might be made for industries or groups of firms where special need could be proved. In the event the munitions manufacturers apparently preferred to get their relief in the form of special depreciation allowances,[1] and the merchants for whom the second concession was intended did not make use of it,[2] so that the last of these concessions was by far the most important. The rules by which it worked were not published by the Board of Referees, but relief was mainly given for fluctuating profits, or special risks, whether inherent in the trade or due to war trading conditions. In addition, this clause allowed differential treatment to be given to concerns with wasting assets.[3]

The allowance of special statutory percentages considerably increased the high profits element in E.P.D. It is not possible to say how many firms benefited thereby, since the Board of Referees wisely refrained from making special rulings for individual concerns. Over 130 group rulings were made,[4] giving additions to the normal statutory percentage ranging up to 29½ per cent. The majority of rulings, however, awarded quite a low increase, and those groups which received the highest additions were often extremely small—no more than a couple of firms operating on a

[1] See below, p. 77.

[2] It was, however, used by fire, accident, and general insurance companies who were consequently taxed on the capital at stake—taken to be equivalent to half the net premiums of the relevant year; cf. Haig, p. 223.

[3] Defined in practice as assets with less than 50 years of expected life.

[4] For a complete list of the rulings see Haig, op. cit., pp. 134 ff.

risky business in some remote corner of the world. Thus it does not seem that the concessions were sufficient to alter the character of E.P.D. as a war profits tax. At the same time, the concessions for low profits were fairly strictly confined to industries where it was reasonable to expect that profits would recover, and hence where there was a good economic case for special treatment. They were not available for depressed or declining industries in general.[1]

For companies choosing the profits standard it was only necessary to apply a computation of capital to changes in investment as they occurred. This was a simple matter and did not destroy the logic of determining the capital invested by listing the assets at cost, since it was concerned almost entirely with quite recent history. The necessity for computing total capital employed being confined to concerns choosing the percentage standard, it was not anticipated that the concept of capital used would have very important effects, however it was defined. The capital concept was in fact determined by the profits it was intended to tax, although Stamp maintains that the capital concept was the primary decision.[2] The profits which were to be subject to E.P.D. were those realized on the proprietors' capital actually employed in the business. In the first place this necessitated a more rigorous deduction of debts and loan capital than was required for income tax, where the tax on debts might be deducted at the source and an adjustment made subsequently. It also implied the exclusion of investments. Thus came about the anomaly that E.P.D. was levied neither on one logical basis—the yield of the total capital employed in the business, nor on the other—the yield of shareholders' capital, however used by the management.[3]

It is clear from Stamp's discussion that the decision to exclude loan capital was adopted without any deep conviction.[4] On the whole it operated to the advantage of the revenue, since the capital invested was reduced more than proportionately to the profits. On the investment side there was some difficulty in determining when capital should and should not be regarded as employed in the business. Broadly speaking, both holdings in government

[1] But the right to choose the percentage standard provided a general blanket relief for the unprosperous

[2] Stamp, p 153

[3] As was the American practice See also above, pp. 50 ff.

[4] Cf. Stamp, p. 154, where it is defended in a very obscure argument.

securities and in other companies were regarded as outside the business, but capital held on deposit for not more than a year was considered to be so temporarily invested that it should be included in the capital computation.

The exclusion of investments led to the awkward result that concerns whose principal business consisted of the making of investments would have escaped the tax completely. Their investments were therefore expressly included, with the provision that proper allowance was to be made on any interest, &c., received on which E.P.D. had already been paid. This peculiar arrangement, which mainly affected life insurance companies, banks, and finance companies, was of course entirely illogical. The necessity for it arose merely because in the absence of an excess income tax there was no other method of reaching the profits of such concerns. Owing to the extent to which working capital had to be increased as prices rose, the capital concept did in the end become of first-class importance,[1] and it is clear that the decision to exclude debts was regretted by some of the revenue officials.[2] Nevertheless it remained a fundamental principle of British excess profits taxes.

The general rules determining profits for E.P.D. were similar to those governing income-tax practice. The main difference was that the annual value of fixed property which would for income tax have been assessed under Schedule A was counted as a profit and combined with the annual profits assessed on Schedule D principles. Owing to the fact that income tax is perpetual, the incidence and assessment of particular expenses and profits between different accounting periods is a matter of small importance. If a transaction escapes one year it is very likely to get caught in another. In the case of a temporary tax, however, and particularly one where the rate is frequently changed, it becomes absolutely vital to determine accurately and finally the exact profits for each particular accounting period. Any failure to do this opens wide the door to evasion, for which the possibility of increasing profits in the future by extra expenditure now always provides a motive.

With this in mind an attempt was made to guard against the more

[1] Stamp, op. cit., p. 154, states that the allowance for increased capital 'became . . . of greater importance both absolutely and relatively than the pre-war standard of profits itself'.

[2] Haig, op. cit., p. 83, reports that by 1920 the authorities were inclined to believe that it would have been more equitable to include debts in the capital employed and not to deduct the interest from the profits.

obvious forms of evasion in the basic Act of 1915. The Inland Revenue were given power to disallow apparently artificial transactions made for the purpose of reducing profits. In a period of rapidly changing prices, however, it was not easy to spot the extent to which normal transactions might have been given an artificial flavour. But the easiest and most paying of all methods of reducing profits remained that of increasing the remuneration of officers—directors, managers, or employees. Under the 1915 Act the Inland Revenue were empowered to disallow any increase in the remuneration of 'directors, managers or persons in the management of the trade or business', in excess of their remuneration in the last prewar trade year, except under special circumstances. In practice it appears that an increase of less than £2,000 was generally allowed.[1] It does not take much imagination to see that these provisions against evasion by artificial transactions or by increasing remuneration would be quite inadequate in face of a really strong incentive to evade.

The inroads which excess profits taxes make into reserves if there is any degree of price-rise makes it essential that generous depreciation allowances should be included. This was not neglected in E.P.D. To deal first with two small but important cases, concerns whose investments were liable to tax were granted an allowance to cover any fall in their value not due to a variation in profits. This allowance might be claimed whether the securities had been realized or not.[2] Secondly, local authorities which had to provide for statutory sinking funds on their trading services were allowed to deduct the annual quota before calculating profits.

Under the basic Act of 1915 an allowance might be made, at the discretion of the Inland Revenue, for loss due to the postponement of renewals or repairs, or for exceptional depreciation or premature obsolescence due to the war. Special relief was also granted to munitions and other firms which had installed machinery for war purposes which would not be wanted afterwards. The special depreciation in E.P.D. was wider than the parallel income tax allowance, in that assets other than machinery and plant were included. It could be extended, for instance, to the writing down

[1] Cf. Haig, p. 44. For the less rigorous provisions of E.P.T. see below, pp. 99–100.

[2] A parallel concession was that where government securities were included in capital, allowance was made both for their appreciation and depreciation; cf. Haig, p. 42.

of patents with the lapse of time—so far as the fall in value was not offset by an increase due to accumulated goodwill. The amount of the E.P.D. allowance was also more generous. The amortization allowance might at the discretion of the Inland Revenue be anything up to the total difference between the pre-war or cost value and the post-war selling price of the equipment. It has already been noted[1] that one method of evading liability to E.P.D. was by the premature scrapping of machinery. So far from attempting to discourage this, the authorities granted obsolescence allowances for machinery which was scrapped, even if there was no immediate intention of renewing it. The government's desire to increase the supply of scrap apparently exceeded their apprehension of tax evasion.

In all questions of obsolescence and depreciation, full discretion was given to the Inland Revenue, with appeal to the Board of Referees. There was thus complete administrative flexibility. Moreover, *pari passu* with the development of E.P.D. an extension and codification of income-tax depreciation rules was taking place. Thus firms enjoyed a quite unprecedented relaxation of fiscal practice during the war period. It will be noted, however, that these regulations were concerned with the valuation of fixed capital. There was no parallel allowance in respect of the increased difficulty of holding adequate supplies of working capital as prices rose. This omission was the cause of grievous difficulties later on.[2]

Ultimately by far the most important method by which relief was given for depleted reserves of all kinds was by the working of the suspense accounting principle, whereby a decline in profits in one period could be set against tax paid in previous periods. To appreciate the full importance of this basic principle it must be remembered that the rate of tax varied from year to year. The Act of 1915 imposed a rate of 50 per cent. for the first twelve months of the taxable period.[3] From that time the rate was raised to 60 per cent. For accounting periods after 1 January 1917 it became 80 per cent., for the calendar year 1919 it was lowered to 40 per cent., and from then to its repeal stood at 60 per

[1] See above, p. 44. [2] See below, pp. 82 ff.

[3] Since liability to different rates was determined by the accounting dates of firms, not by calendar or financial years, the operation of changes in rates began at different times for different firms. Thus the first twelve months of the taxable period of a taxpayer began with the beginning of the first accounting period which closed after 4 Aug. 1914.

cent. The effect of suspense accounting was that liability was determined afresh every accounting period for the whole period which the tax had run, at the rate then current. Thus if general losses had been made in a period when the rate was very high it would have been quite conceivable for the total tax payment to be negative.

It seems probable that the framers of the Act of 1915 intended only to provide for the casual losses which they expected would be experienced in the disturbances of a war period. They can hardly have given much consideration to the possibility of the tax extending over enormous movements of boom and slump.[1] When these occurred in 1919–21 the effect was so devastating as nearly to wreck the operation of the tax. The history of E.P.D. at the end of the war, however, raises such important issues that we must postpone them for the moment. It is first desirable to review the changes which had to be introduced into the tax to deal with the gradual rise in prices from 1915 to 1918.

The very first year after the imposition of E.P.D. the authorities realized that their efforts to forestall evasion were insufficient. Most of the common forms, such as expenditure on premises and advertising, were too amorphous to catch by anything except administrative discretion. But the clause affecting directors' remuneration was tightened up.[2] By far the most striking leakage which had developed, however, was through the sale (or exchange) of ships at enormously increased prices. Since this was regarded as a capital transaction in English tax law, the profits arising were exempt from tax, and the purchaser was able to evade future liability to E.P D. by starting in with an artificially inflated percentage standard. A similar possibility of selling and exchanging assets existed of course in other trades. But the transactions were smaller

[1] The first time the authorities were faced with a really big repayment the law was altered and the revenue did not suffer This was in the case of the shipping industry, where very large profits were made in the first two years of the war. After the imposition of control and the requisitioning of ships, the profit margin was drastically reduced. As a very large proportion of the yield of E P.D. up to that date had come from the shipping firms, they had enormous sums standing to their credit. With an 80 per cent. tax they stood to receive back almost the whole of this. The settlement was a compromise whereby shipowners were repaid, but only to the extent of the percentage standard, thus at a very much lower rate than on the profits standard, which included the record year 1913. For a full account of the episode see Stamp, op. cit., pp. 191 ff.

[2] For details see Haig, op. cit., pp. 43–4.

and consequently less attractive. After considerable discussion[1] an amendment was enacted whereby the standard, and position as to reliefs, were transferred unaltered from vendor to purchaser. The purchase of ships was thus a considerably less attractive proposition, and in that way the vendor was made to bear his share of the burden.

In 1917 Mr. Bonar Law, the new chancellor in the Lloyd George government, announced that he intended to raise the rate of E.P.D. to 80 per cent. This was mainly a political move. The failure of E.P.D. to check the growth of profits (which in the absence of adequate price control it was naturally powerless to do) had already given rise to the demand for a 100 per cent. tax. The raising of the rate to 80 per cent., it should be noted, was contrary to the advice of the previous chancellor, Mr. McKenna, who maintained that the combined rates of E.P.D. and income tax put too heavy a burden on industry. It was also against the most vehement protests of the officials,[2] who urged that 70 per cent. was the highest practicable rate. The truth was that the higher rate, in conjunction with the price-rise which was taking place at an accelerated rate, already contained an element of confiscation of the capital of firms. There was thus a greatly increased anxiety among business men to preserve what they could by inventing new methods of evasion, and at the same time a real need for the relief of firms whose opportunities of this kind were few.

The Finance Act of 1917 consequently contained a number of additional concessions which were intended to mitigate the effect of the new rate. Capital losses sustained in any of the six pre-war trade years might be neglected in computing capital employed. Where a loss had been made by one of a group of companies whose standard was used by the group, it might be ignored. The exemption limit was raised for small firms whose pre-war profit was under £500 and whose current profits were less than £2,000. To the original £200 excess exempted they were allowed to add a fifth of the difference between their profits and £2,000.[3] More important than these was a general increase in the statutory percentages,

[1] Described at length in Stamp, op. cit, pp. 186 ff.

[2] These protests were, however, sufficient to prevent Bonar Law from succumbing to political pressure and imposing a 100 per cent. rate, either then or in the following year.

[3] If a loss had been sustained in the accounting period, the fifth might be calculated on the whole difference between the standard revenue and £2,000.

made on the recommendation of the Board of Referees in order to allow for the rise in interest rates. Unincorporated firms were given an extra 1 per cent. in the basic percentage. For the introduction of new capital, or for new firms, an extra 3 per cent. was allowed on the rates as they then stood—making them 9 and 11 respectively. Another section increased the number of years in which pre-war capital might be the subject of adjustment on the ground of not being fully remunerative, from three to six. The 80 per cent. rate may have been politically unavoidable, but there is little doubt that these concessions were also extremely necessary on considerations of equity for small and new firms.

Most of the new forms of evasion were no more amenable to legislative control than the old. But action was taken in respect of one important method—the disposal of stocks in bulk, 'out of the course of trade'—a proceeding which enabled the profits to be classed as capital gains, just as they had been in the case of ships at an earlier stage. Indeed in the spring of 1916, when the ships trouble was in full swing, McKenna, foreseeing that serious leakage might occur in respect of other assets, had asked for a general clause making all such sales liable to E.P.D. But the ship problem was solved on other lines, and the matter did not again become acute until the Scottish distillers, in reaction to the 80 per cent. tax, began to dispose of their enormously appreciated stocks of whisky in bulk. This evasion was dealt with by frankly taxing the capital gain—for the first time in British fiscal history. An amendment to the Finance Act of 1918 announced that profits arising from the sale of trading stock 'otherwise than in the ordinary course of trade' would be deemed to be 'profits arising from a trade or business', and so liable to E.P.D. Owing to the complications arising where firms had been wound up, it was not possible to make the clause retrospective, so that it operated only from the date of the announcement (22 April 1918).

By this amendment the conversion of E.P.D. into a tax on business capital (which would in any case have resulted to some extent from the inflation) became avowed as the deliberate policy of the government. It is not surprising that business became alarmed. At least from the spring of 1918 the end of the war began definitely to be foreseen and planned for. Business men began to ask themselves on the one hand how they would get rid of redundant stocks which would not be wanted for peace-time

production, and on the other, what losses they would have to bear on products made with raw materials bought at war prices, but saleable only at the very reduced prices which were expected to rule immediately after the war.

Agitation on this head had already started when the 80 per cent. rate was under discussion. A private Bill amending the Finance Act of 1917 had been introduced in conjunction with various trade deputations, of which the most important was that of the Association of Controlled Firms.[1] The proposal was that the stock held at the beginning of the operation of the tax should be regarded as normal both in quantity and price. For every accounting period a similar quantity should be valued at the price of this pre-war normal stock. Any excess would be valued according to the ordinary principle of cost or market price. At the end of the final accounting period under the tax, any deficiency might be made good, being reckoned into the chargeable basis for the final period, while a space of two years would be allowed for the disposal of any surplus stock, which would then be subject to tax or refund, according to the actual prices realized.

The adoption of this suggestion would have presented all firms indiscriminately with a large hidden reserve of stock which would be heavily undervalued, except under the unlikely assumption that prices immediately fell back to the pre-war level. It would also have deprived the government of a considerable amount of revenue on past assessments, which if prices remained high would have been quite unjustifiable, and in any case would have been very awkward. This was the opinion of a committee of accountants to whom the suggestion was referred.[2]

The authorities therefore compromised. A White Paper was issued which promised in the first place a period of two years after the close of the war for the disposal of stock appearing in the last accounting period. Losses on the realization would be taken into account in the final settlement, and an allowance at these revised prices would be made on the part unsold.[3] Secondly, in the case of firms belonging to trades which worked on durable[4] raw materials, and habitually kept 'base stocks' of them on hand,

[1] Afterwards reorganized as the F.B.I.

[2] Cf. Haig, op. cit., Appendix F. [3] Cf. Stamp, op. cit., p 207.

[4] Defined as materials so imperishable that a stock might reasonably be kept intact for a period as long as the war.

the practice would be recognized for E.P.D.,[1] on the basis of the minimum amount held at any stock-taking in the three pre-war trade years. Thirdly, in respect of a limited class of raw materials of a non-durable nature which co-operated very closely with fixed capital,[2] the depreciation allowance might be extended to include such working capital. Fourthly, for other firms which in fact kept base stocks but which did not fall within the narrow classification under the second head, there would be allowed at the final valuation a deduction equal in money terms to the difference between the base stock valuation and the normal (cost or market-price) valuation of the stock held at the end of the standard period.

The first concession removed the fear that if E.P.D. were repealed immediately after the war, all means of recovering losses would be sacrificed. But if prices had fallen as much as they did in fact in 1921, and there had been no further repayment than on stock losses realized in the first *two* post-war years, firms would have been in a very awkward position, and would have had to borrow heavily to restore their working capital to a level at which they could have maintained a normal output. The second concession, which required the firm to have used the base stock method habitually as well as to belong to an industry working on a particular kind of raw material, was so narrow as to be practically useless. The same objection applied to the third concession. The fourth again would be quite inadequate by itself, if prices continued to fall over a considerable period.

Before long the government was forced to extend its concessions. Lord Stamp has revealed that the next step was the result of an attempt on the part of Industry to circumvent the Treasury by appealing to the Ministry of Reconstruction.[3] We have reason to be grateful for its success, since the report of the resulting committee (on Financial Risks attaching to the Holding of Trading Stocks) contains an excellent summary of the economic problem, as well as an interesting suggestion for dealing with the whole question of depletion of reserves and the end of the tax.[4] As regards stocks, the concession which the government put forward was that if the profits of the four years succeeding 31 August 1921 were, owing to

[1] Since this practice was in fact allowed for income tax, it would have required fresh legislation to deny it for E.P.D.

[2] Such as metal kept to a constant level in a galvanizing tank.

[3] Op cit., p 205.

[4] The report is quoted at considerable length by Stamp, op. cit., App. I.

the fall in prices,[1] less than the percentage standard, repayment of 80 per cent. of the deficiency might be claimed, provided that this did not exceed 40 per cent. of the average excess profits of the last two chargeable years, or the aggregate duty paid by the firm. Although this was clearly based on the recommendation of the committee, it entirely failed to do justice to their analysis of the problem.

In their evidence before the Committee on Financial Risks business men had emphasized that the main shortcomings of the White Paper concession were: first that it only provided relief on one turnover of working capital; and secondly that the base stock concession operated very unfairly between different industries. Some type of hidden reserve should not have been considered a privilege for the few, but should have been put within the reach of all. The committee came to the conclusion that the root of the trouble was the 80 per cent. rate. Their witnesses were unanimous in maintaining that the depletion problem would never have arisen if the rate had been kept below 70 per cent. Consequently the remedy the committee preferred was to drop the rate for the current period from 80 to 65 per cent., on the condition that the 15 per cent. difference should be retained as a reserve and not distributed as dividends. They pointed out that such an amendment applied to the current period could make no difference to profits, since they had already been declared.

In case the government felt that it was unable to forgo any immediate revenue, the committee put forward an alternative plan, which in a truncated form appeared as the concession mentioned at the top of the page. The full suggestion, however, is worthy of careful note. It was that a part of the tax receipts (at the 80 per cent. rate), although temporarily handed over to the government for safe keeping, should nevertheless be regarded as deferred reserves, which might be paid back at a later date. This deferred reserve would for each firm be equal to 20 per cent. of the average excess profits in the last two accounting periods, as calculated for E.P.D. (and including accrued interest). If after five years from the end of the war a firm found that its profits had fallen below the percentage standard, it might claim to have the deficiencies repaid from its reserve, so far as it would go.[2] In no

[1] It is not clear how this criterion was to be determined.

[2] The adoption of this scheme would have made the first concession of the

case, however, would more than 80 per cent. of the total deficiency be repaid, so as to retain sufficient incentive for good management during the five years' interval. If a firm wished to cash in on its reserve after three or four years it might do so, by giving due notice. It would receive of course only a *pro rata* amount of the reserve.

The weaknesses of this scheme were the obvious difficulties of proving the cause of low profits and of providing sufficient incentive for good management. While it would certainly have been some help to the very weak, it would have done nothing to alleviate the quite real troubles of the slightly less weak. Nevertheless some such plan would, in the event of a speedy repeal of E.P.D., have provided help where it was most needed, in a way that was economically sensible and desirable.

While the government did not see its way to pay any further attention to the Report of the Committee on Financial Risks, the final concessions as regards stocks at the close of E.P.D. were somewhat wider than those already enumerated. A trader was allowed to value his closing stock at the prices of the end of August 1921 (by which time wholesale prices had already fallen 135 points from the peak of the previous year[1]) and to deduct the difference from the last year's profit, subject to a maximum deduction related to the percentage standard. He was also given an allowance on forward contracts which had already been made. In addition he could either use the White Paper concession, or the relief based on the Financial Risks Committee's recommendation. As it turned out, the stocks question would not have been so serious as many traders feared, even if E.P.D. had been repealed very soon after the war, since prices did not fall to anything like their 1914 level.[2] No information is available as to the use made of the various alternatives, but in the event any relief they afforded was completely swamped by the flood of discharges and repayments under the suspense accounting principle, to which we must now turn.

No sooner was the war over than the evils inherent in an 80 per

White Paper unnecessary. The committee, however, felt that it should be retained as an alternative for the sake of firms which did not expect to be sufficiently depressed to apply for the benefit of the deferred reserves scheme.

[1] From 325 to 190 (1913 = 100).

[2] The maximum fall was one of 171 points—from 325 in May 1920 to 154·5 in August 1923 (1913 = 100).

cent. rate began to show themselves with a vengeance. There was no longer any moral restraint on evasion, and firms prepared to equip themselves with every imaginable device which might facilitate the earning of future profits. The cessation of hostilities led naturally to a small immediate price-fall of 20 points from November 1918 to March 1919.[1] This and the general dislocation of business profits were enough to persuade the government —under strong pressure from industrialists—that the armistice recession was a genuine slump. Consequently, in the budget of 1919 the rate of E.P.D. was halved. This was most unfortunate in every respect. Hardly had the Finance Act been passed than industry set out on an enormous and inevitable restocking boom, just at the moment when the needs of the government for finishing off the war and liquidating its commitments were most urgent. The fall in the rate of E.P.D. fostered the belief that in the following budget it would be entirely removed. Hence the change in rate, by encouraging investment for a tax-free future, fomented the competition between private enterprise and the government for the limited amounts of loan capital which were available. Too late the government perceived its error and, in the forlorn hope of directing some of the boom profits into the Exchequer, in the 1920 budget the rate of E.P.D. was raised to 60 per cent. But the boom had already broken, and the government found itself liable to enormous repayments at a comparatively high rate of tax.

It is not easy to get at the real facts of E.P.D. from the published statistics. In the first place the system of suspense accounting meant that no assessments were finally complete until the tax was finished. As we shall see, many hundreds were not completed until very many years after that. Secondly, pre-payments were encouraged by a small interest payment. It is unlikely, however, that they amounted at any time to more than about £15 millions. But the most serious difficulty in interpreting the situation at any point of time lies in the lag of assessments. Delayed assessments were partly a matter of policy—they were a way of avoiding financial embarrassment or even fiscal bankruptcy for the taxpayer. In the confused state into which E.P.D. drifted at the end of the war they were also largely unavoidable.

The net receipts from E.P.D. (including the small amounts of

[1] On the *Economist* Index. The *Statist* index showed a fall of only 15 points.

the Munitions Levy[1]) are shown in column 1 of the accompanying table. They cover the period from the outset to the end of the financial year 1924—three years after repeal. The immediate effect of carrying the tax over the depression is shown by the enormous rise in set-offs in 1921. These were mainly composed of discharges (£80 millions) and repayments (£91 millions). But the position was really much more serious than appears at first sight. At the close of the duty a bill of some £600 millions, already assessed or to be assessed, was hanging over the head of industry.

Excess Profits Duty and Munitions Levy (£ millions)

Year (financial)	*Net receipts*	*Set-offs (E.P.D. only)*	*Arrears*
1915	0·19	.	..
1916	141·61	16·03	17·17
1917	223·12	25·27	76 71
1918	283·98	42 44	164·10
1919	289·21	73·92	217 10
1920	218·10	80·32	287·26
1921	29 67	179 25	292 05
1922	1 12	128·10	211·35
1923*	−1 87	64·58	161·60
1924	2 76	40 27	131·06

* Last two years G.B. and N. Ireland only.
(From Reports of Commissioners of Inland Revenue.[2])

By the end of the financial year 1924 £131 millions of these liabilities had been assessed, but were in arrears.[3] About £100 millions

[1] For details of this tax see below, p. 90

[2] Cf. also Stamp, op. cit., pp. 206 ff

[3] It would be very instructive if it were possible to analyse the figures for arrears. Briefly arrears may be: (i) Simple arrears arising through failure to collect admitted liabilities (settled in amount)—the taxpayers' liquid assets having been absorbed in the meantime in expansion, in the early years no doubt often on war production (in this case there would probably be offsetting sums due from various government departments for work delivered and not yet paid for); (ii) Assessments fairly precisely computed but partly in dispute —for instance on account of depreciation allowances to be settled at a later date; (iii) Amounts specifically held over against deficiencies already known or expected to be materializing in the succeeding period; (iv) Amounts wholely estimated (and sometimes far higher than the true liability, and thus subsequently written off), in cases where the taxpayer has failed, wilfully or otherwise, to produce accounts and figures in due time—not necessarily for reasons connected with E.P.D. at all. It is probable that the first class was responsible for the great accumulation of arrears at the end of the war. It provides direct evidence of the effect of excess profits taxes on working capital under inflation

more remained to be assessed. Of this £230 millions only about £20 millions was ever collected—and that only gradually over the next fifteen years. The remainder of the accounts were quietly closed.[1] It is impossible to estimate accurately what would have been the position if E.P.D. had been repealed a year earlier. It may be hazarded that most of the 1920 receipts would have been collected, since they probably dated from earlier years. The volume of ultimate repayments would of course have been very much smaller. The adequacy of the stock allowances would then have been put to a drastic test.

In reflecting on the experience of E.P.D. in relation to the effects of later profits taxes, it must be borne in mind that the rate was only high for a short time, that the basic Act provided for a wide choice of standard and allowed great flexibility in administration, that in spite of this further concessions had to be introduced with the course of time, and that finally after the tax had been repealed about £450 millions was repaid[2] or discharged. E.P.D. was certainly not an economical tax.

(see above, p 57 ff.). (The Germans had a blocking device specifically to deal with this problem—see below, p. 138.) It is perhaps hardly necessary to point out that most of these causes of arrears were the fault of the tax, rather than of the taxpayers or the revenue authorities.

[1] A sudden rise in set-offs in 1930 from a level of about £10 millions to £30 millions suggests that some of the victims had been pursued even to their death.

[2] That this tremendous negative revenue attracted so little attention was probably due to the fact that in practically every year a small positive receipt was brought into the budget accounts.

CHAPTER X

FROM E.P.D. TO E.P.T.

IN the course of the war of 1914–18 several small specialized excess profits taxes sprang up, and were administered somewhat clumsily by the departments which were concerned with the industries to which they applied. Of these the most important were the Munitions Levy and the Excess Mineral Rights Duty. The former was actually the first excess profits tax to be imposed in this country, and was part of Lloyd George's bargain with the trade unions. It was equivalent to a 100 per cent. excess profits tax[1] on the 4,000 'Controlled Establishments', and might be taken as a warning against total confiscation of excess, but for the difficulty of allowing for the ineptitude of the Ministry of Munitions as a Revenue Department. Even so there are some points to be gleaned from the experience of the munitions levy, as we shall see later. After a short period under the Ministry of Munitions the administration was transferred to the Inland Revenue, and eventually the levy was merged completely with E.P.D. The total receipts to the end of 1924 were about £50 millions, a fantastically small sum when the activity of the munitions industry is borne in mind. The lag in collection was even more serious than for E.P.D.; consequently in most years outstanding arrears were relatively higher, and the confusion even greater.

In 1920, as an additional effort to rectify the generosity of lowering the rate of E.P.D. in 1919, a tax of 5 per cent. was imposed on the total profits of companies (the Corporations Profits Tax). C.P.T. should probably be regarded as a timid imitation of the American high profits tax,[2] since the ostensible reason for imposing it was that during the post-war boom profits had been unreasonably high. The fact that only companies were liable to C.P.T. suggests also that it was the British counterpart of the discrimination against big business which was so marked a feature of post-war fiscal legislation elsewhere. Generically, however, C.P.T. was not in any way a high profits tax. It merely imposed a burden

[1] The levy was imposed on all excess over 20 per cent. above pre-war profits. It was thus a 100 per cent. tax with an exemption minimum of 20 per cent. of the excess.

[2] See below, p. 118.

similar to that already inflicted by Income Tax Schedule D. Since C.P.T. was thus not a war profits tax at all we need not bother about it further. It was a poor affair, uneven in its incidence and easily evaded. It did not long remain part of the fiscal system.

The revival of war profits taxes must be dated from the beginning of the rearmament campaign in 1937. But the tax that emerged from the budget discussions of 1937—the second version of the National Defence Contribution—was again not an excess profits tax, but merely another version of C.P.T., a tax on the total profits of firms, both incorporated and not incorporated.[1] The only importance of N.D.C. for our investigations is that it is still in effect as an alternative to E.P.T., being levied whenever profits are too small to attract E.P.T., and putting an upper limit to the allowance for deficiencies under the suspense accounting principle.[2]

The first, abortive, version of N.D.C. is worth a glance because, although it was a worse tax than the one which was adopted, it was a deliberate attempt to tax the margin of growth. It was to be levied according to a graduated scale, progression depending both on the degree of expansion of profits and on the percentage return which they represented on the capital employed. A minimum return of 6 per cent. on the capital was exempt from tax, even if it included an excess over the standard profits. From that point the expansion of profits was to be taxed at 20 per cent. so long as the current profit did not represent a return of more than 10 per cent. on the capital. In the higher ranges of profit and growth of profit different rates of tax were applied to the successive fractions of growth, according to the general rate of return on capital, up to a maximum rate of $33\frac{1}{3}$ per cent. on the whole growth where the current profit exceeded a return of more than 15 per cent. on the capital employed. The scale was thus extremely complicated,[3] and in addition the calculation of liability required in every case a full capital computation,[4] even although it was permissible to choose a profits standard as a basis.[5]

[1] N.D.C. again does not operate over the whole industrial field. Public utilities are excluded, their profits being taken to be regulated already.

[2] The operation of N.D.C. was originally limited to the period 1937–41.

[3] For details see *Economist*, 24 Apr. 1937.

[4] This was not an inevitable consequence of the decision to impose a progressive tax, since progression might have been graded according to the percentage excess over standard profits; see above, p. 48 n.

[5] In this, and in some other respects, N.D.C (i) clung more closely to the precedent of E.P.D. than is the case with E P.T.

The trouble and expense involved in the full capital computation was an extremely unpopular feature of the proposed tax, but what really secured its rejection was the inadequacy of the standard period. In place of the wide choice of years allowed for E.P.D. the standard was fixed as the average of 1933–5, which so far from being boom years represented only the early stages of recovery from an exceptionally deep depression. Since in 1937 armament expenditure was still on a very modest scale, the effect of N.D.C. (i) would have been to tax not the excessive profits of rearmament, but the first tentative steps of normal recovery, a proceeding for which there could be no economic justification.

If and when armament activity expands to a point where it begins to set the tempo for industry as a whole, the case for taxing additional profits clearly becomes much stronger. The government apparently judged this point to have been reached by the spring of 1939, since a proposal to tax the excess profits of munitions firms was included in the budget. Armaments Profits Duty, unlike the munitions levy, was not confined to controlled firms, but was to be assessed on the armament activity of any firm engaged on such work to the extent of a turnover of at least £200,000. It thus required in the great majority of cases an accounting dichotomy between armament and non-armament production, not a particularly easy operation to perform. The arbitrary choice of a relatively high exemption limit also appeared likely to give some trouble, for instance in calculating liability where a number of sub-contracts were in operation. Apart from its limited scope, A.P.D. was an excess profits tax in the E.P.D. tradition. It had a profits basis with a choice of standard years (1935, 1936, or the average of either with 1937). The nominal rate was fixed at 60 per cent., but as income tax and N.D.C. were allowed as deductions, this was reduced in fact to just over 40 per cent. A.P.D. was not taken very seriously by industry. Armament activity was not in the summer of 1939 on a large enough scale to produce heavy additional profits, and it is unlikely that the tax would have brought in much revenue. It was viewed mainly as a political measure.

In the first war budget A.P.D. was merged with E.P.T., the new general tax on excess profits. No revenue had in fact been collected from A P.D. Its real importance was that it was used as the basis for E.P.T. A number of features were transferred direct—for instance the standard years. Further, the Chancellor, wisely

or unwisely, managed to curtail the discussion of the terms of E.P.T. by reminding the House that they had already agreed to the principles when presented to them in the form of A.P.D. To the examination of these principles we must now turn.

CHAPTER XI

E.P.T. (1939–)

ALTHOUGH E.P.T. is clearly in the direct line of succession from E.P.D., in many respects it is a very different tax. The original E.P.D. occupied only ten pages of the Finance Act, plus a Schedule of about five pages of interpretation. E.P.T. with its explanatory Schedule took up twenty-two pages of the second budget of 1939, and this was followed by over sixty pages of amendment, extension, and explanation in the first budget of 1940. This growth is partly due to the increased complexity of the industrial structure since 1914. Among other points, special provision is made for two forms of organization which have greatly increased in importance in recent years. Firstly, many small firms which would previously have been unincorporated have now taken advantage of legislation passed only shortly before the last war. E.P.T. contains many references to the director-controlled company. E.P.D. was less concerned about it. Secondly, combination and amalgamation have now spread over the entire industrial field, and the problems of the holding and subsidiary company give rise to additional complications in administration.

These developments are not the only cause of the complexity of E.P.T. Detailed enactment may serve as a substitute for administrative discretion.[1] The suggestion that this principle is at work is borne out both by the tone of the originating Act and by the smaller opportunities for appeal to the Board of Referees which it allowed. Although substantial concessions have since been introduced, it is clear that E.P.T. was meant to be, and will no doubt prove, a more drastic tax than E.P.D.[2] This new attitude

[1] An instance of this is the introduction of the word 'average' before 'capital employed'. This implies that instead of leaving the Inland Revenue to choose a convenient date during the accounting period for the capital computation, every change must be carefully balanced up throughout the period.

[2] The administrative discretion allowed in E.P.D. went far beyond what was customary in British fiscal practice, see the striking remarks of Haig, op. cit., *passim*, especially pp. 94 ff. The main grounds of appeal to the Board of Referees are. I, under the Finance (No I) Act, 1940: (i) for the determination of an Alternative Standard (section 27 (iii)); (ii) for disallowances by the Inland Revenue of unwarranted expenditure or exorbitant directors' fees (section 32 (ii)); (iii) for disallowances by the Inland Revenue of exceptional depreciation

is partly due to the change in industrial and social outlook which has taken place in the intervening years. Industry has learnt to bear more and Labour to ask it. It may be surmised that a main purpose of the difference is the desire to accelerate collection by removing as many of the opportunities for litigation as possible. It is not certain, however, that the more rigid methods of E.P.T. will be as successful as the flexibility of E.P.D., or even that it will be possible to administer them without substantial modification. (Already in the first budget of 1940 a marked extension of flexibility was conceded, and more was to follow in 1941.) The generally sterner character of E.P.T. will appear as we contrast its provisions with those of the earlier tax.

Both the professions and the profits of 'husbandry' were outside the scope of E.P.D. The professions are still excluded, but the definition appears to be drawn somewhat more narrowly than before.[1] In practice, however, much depends on judicial interpretation, since an unambiguous definition of a profession has not yet been evolved. On the other hand, husbandry is now included. However, as the effective exemption limit for E.P.T. (the Minimum Standard)[2] is fairly high—substantially higher than it was under E.P.D.—only the larger agricultural enterprises are affected.

In the same spirit the choice of standard is less considerate. There is no general licence to elect for the percentage standard. The privilege is confined to new firms, started after 1 July 1936.[3] For the profits standard the choice of years, following A.P.D.,[4] is

in any accounting period (section 33 (ii)); (iv) in case of a succession, from adjustments of chargeable periods by the Inland Revenue (section 38 (iv)); (v) for the determination of the share of the profits of a member of a group of companies in operation before 1 July 1936 (5th Schedule, Part III (2)); (vi) from reconsideration of the conditions affecting a group of companies by the Inland Revenue at the end of a Relevant Period (5th Schedule, Part II (3) (i) (2)). The Board of Referees may act either on the application of the Inland Revenue, or on appeal by the Principal Company II., under the Finance Act, 1941: (i) from awards made by the Inland Revenue, where losses are added to capital employed (section 30); (ii) from an award in respect of wasting assets (section 31).

[1] Cf. H E. Seed, *The Excess Profits Tax*, p. 1. The profits of an individual or partnership are excluded from E.P.T. if they depend wholly or mainly on his or their personal qualifications. [2] See following page.

[3] On the other hand, the statutory percentage (8 and 10 per cent. for ordinary and for director-controlled companies respectively) both for new businesses and for additional investment (6 per cent. for withdrawals of capital) is nearer to the final concession of E.P.D. than to its original rates.

[4] 1935, 1936, or the average of either with 1937.

not so wide as it was for E.P.D., and the years are not so good. The best year, 1937, can only be used in an average. The standard chosen for E.P.T. may be said to represent normal profits very fairly, and is in line with the original intention of E.P.D. which was relaxed in debate. It is thus fiscally unimpeachable, but it must be remembered that there are good economic arguments for limiting the number of firms which will fall under the tax.[1] It has also been argued above[2] that a war profits tax has certain economic advantages over a high profits tax, and most of these modifications have tended to make E.P.T. more purely a war profits tax. The smaller use of the percentage standard may also have the advantage of reducing the number of capital computations which have to be made, at least in the early stages of the tax before changes in capital become important. It should thus contribute to accelerating collection.[3]

A further improvement in E.P.T. is the new Minimum Standard, which provides a more ingenious and useful exemption limit for the small firm than did the lump sum exemption of E.P.D. The minimum standard is defined as £1,000, *or* £1,500 per working proprietor (*sic*), up to a limit of £6,000. This limit may be overstepped at the discretion of the Inland Revenue by a further £1,000 per working proprietor, up to the limit of a further £4,000.[4] The minimum standard is available to firms controlled by a single individual and to partnerships, as well as to director-controlled companies. It also covers other companies which are constituent parts of a group of any such concerns. It will be observed that there is no exemption in E.P.T. for any excess profits as such, but the sum allowed in E.P.D. was of negligible value to all but small firms, which now have a much more generous basis.

Apart from the right to use the percentage standard, E.P.D. provided specific relief for fluctuating profits, for capital not yet fully remunerative, and for hard cases such as firms concerned with wasting assets or other special risks. This was done both by

[1] See above, p. 46. [2] See above, ch. v.

[3] Another change which should facilitate assessment and so accelerate collection is the provision that liability to E.P.T. shall begin simultaneously for all firms (at 1 Apr. 1939), and not depend on individual accounting periods as was the case for E.P.D.

[4] This is a striking instance of a concession made between 1939 and 1940. Originally the allowance was £1,000 or £750 per working proprietor, up to a final limit of £3,000.

direct enactment and by the right of appeal to the Board of Referees. In E.P.T. a standardized relief, known as the Alternative or Substituted Standard was designed to take the place of all such special concessions. This consists of a faculty given to the Inland Revenue to award as a standard an amount not exceeding what would be required to cover the fixed interest and dividend obligations of the concern, plus a 6 per cent. dividend on the paid-up ordinary shares.[1] This provision was one of the most bitterly criticized sections of the 1939 Act. Modifications introduced in 1940, however, go far to remodel the substituted standard as a straightforward Percentage Standard, although of somewhat limited application. The concession is available to 'trades and businesses', whose profits in the standard period were either zero, or so low as to make them unjust as a standard in the opinion of the Inland Revenue. If the taxpayer is dissatisfied with the new standard awarded to him he may appeal to the Board of Referees, who, if they think that the paid-up capital did not properly represent the value of the assets at the beginning of the standard period, may fix a new standard by revaluing the assets as of a going concern at that time[2] so long as the new valuation does not cause the 6 per cent. limit to be overstepped. Finally, if the firm can prove that it belongs to a depressed industry, this section may be applied even if the paid-up capital did fully represent the value of the assets.

It is clear that the Substituted Standard, even as modified, does not go far towards compensating for the special reliefs afforded in E.P.D. In one case in particular—that of wasting assets—it was almost immediately discovered that further action was necessary. The profits earned by firms with wasting assets are in part repayments of capital; in some cases, tin dredging, nearly exhausted mines, nearly exhausted oil-wells, it may be in very large part. If they increase their output during the war (as it may be very desirable in the national interest for them to do) they are reducing their probable life, and cutting into possible post-war profits very seriously. Their situation is totally different from that of the ordinary business. If no special provision is made for

[1] Eight per cent. for director-controlled companies. The whole of the concessions under this heading (section 27 of the 1940 Act) are available to firms controlled by individuals and to partnerships, at the 8 per cent. rate, substituting for the paid-up ordinary capital the net amounts standing in the capital account(s) of the proprietor(s) at the beginning of the standard period

[2] On the normal method of computing capital.

them, an excess profits tax becomes a special capital levy on this sort of property—a levy for which there can be no conceivable justification. Under E.P.D. their case was looked after by permission given to the Board of Referees to fix special percentages in excess of the ordinary percentage standard; additional percentages of 7 to 10 per cent. were often awarded.[1] The Finance (No. 2) Act, 1940, introduced a very limited relief with a maximum additional 4 per cent (in excess of the Substituted Standard).[2] The actual scale of the allowance was to be determined by the Board of Referees in accordance with the acceleration in the rate of exhaustion of the assets due to the war. Both on grounds of equity, and on the ground of providing a reasonable incentive to the maintenance of output some more generous allowance was urgently called for.

By the Finance Act of 1941 a fuller and more flexible measure of relief was awarded.[3] A maximum allowance of 30 per cent. may be granted where the expected life of the wasting asset is very short. For assets of longer life the relief becomes progressively smaller, ceasing altogether where the expected life is more than fifty years.[4] In contrast to the generality of the E.P.D. relief, the allowance is strictly confined to firms engaged in the extraction of metals and oil, and is only available on receipt of a Treasury certificate that the additional output is due to, and necessary for, the conduct of the war.

For other hard cases the most important further relief introduced after the original drafting of the tax is the provision inserted in 1941[5] that in certain cases the capital employed may be 'written up' by the amount of trading losses sustained prior to the operation of E.P.T. This concession is available both for firms started after 1 July 1936 (in respect of the period between commencement of

[1] Typical additional percentages granted by the Board of Referees were. copper mining in Rhodesia (9), lead mining in West Australia (8), manganese ore *mining in Great Britain* (10), *oil producing in Trinidad* (8), tin mining and dredging in Malaya (7). See Haig, op. cit., pp. 134 ff.

[2] It will be remembered that the maximum which can be awarded under the Substituted Standard is enough to cover debenture interest, preference dividends, and 6 per cent. on the ordinary. This is presumably rather less generous than the straight 6 per cent., which was the minimum standard percentage for E.P.D.

[3] F.A. 1941, section 31 and Second Schedule.

[4] The allowance is available to firms assessed on the Substituted Standard, but not to those assessed on the Minimum Standard.

[5] F A. 1941, section 30.

operations and the beginning of E.P.T.), and for firms which are eligible for the special treatment of the Substituted Standard (from as far back as the beginning of 1929). In the case of the latter the new concession is clearly an extension of the principles on which the Substituted Standard itself is based.

These provisions for hard cases are another interesting illustration of the contrast between E.P.D and E.P.T. Administrative discretion is now strictly limited, and with it the value of the allowances which may be awarded. On the other hand, the scope of the concessions is in some respects wider. Most of them can be adjusted to the needs of the individual concern, and are not merely applicable to a 'class of trade or industry'—in the E.P.D. terminology. The larger number of individual cases which are likely to arise may cause some delay in assessment. On the other hand, the new methods are probably an improvement, both economically and fiscally—if the administrative staff is able to cope with them. In E.P.D. there was no specific provision for depressed firms or industries—other than for the firm that was merely temporarily depressed. But the fact that any firm could choose to be assessed on the percentage standard did in effect provide a general concession for all firms which had been doing badly. This probably led to an unnecessary sacrifice of revenue.

Although they are drafted differently, the allowances for depreciation in E.P.T. do not appear to differ much in effect from those of E.P.D. The grounds of special allowance have been reduced,[1] but the extent of the allowances has been increased. The full Schedule D income tax allowances for wear and tear and obsolescence, including the additions made in 1932 and 1938,[2] are available for E.P.T. whether or not they have already been claimed for income tax, and whether or not the business is one which is assessed under Schedule D. In addition, a special depreciation allowance, similar to that allowed to munitions firms under E.P.D., will be available for equipment installed after 1 January 1937, which after the war proves to be obsolete. The allowance may, at the discretion of the Inland Revenue, be as much as the full cost of the plant. Since the final allowance cannot be deter-

[1] There is no allowance for repairs or renewals postponed owing to the war, nor for depreciation of investments allowed in the capital computation—if any—of ordinary businesses

[2] Broadly speaking, these amounted to some 10 per cent. and 20 per cent. respectively of the former allowances

mined until some time after the end of the war,[1] an interim allowance of 10 per cent. per accounting period[2] may be granted if the Inland Revenue consider that the concession will ultimately be applicable.[3]

As experience was gained in the working of E.P.D. new methods of evasion were successively discovered, and ways of stopping up the loopholes had to be found. E.P.T. is able to draw on this experience. Although the clauses relating to evasion do not appear to be directly related to the specific troubles of E.P.D., it is evident that they have been framed with similar conditions in mind. Evasion in E.P.T. is mainly guarded against by sections dealing with (i) disallowances of improper expenses, (ii) artificial transactions, (iii) successions and amalgamations, and (iv) interconnected companies.

Section 32 confers general powers of disallowance of expenses in any accounting period in excess of what the Inland Revenue considers reasonable, having regard to the nature of the trade or business. In a period of rising prices it is difficult to see how the criterion of reasonableness could be determined, and any except the most flagrant extravagances disallowed. A further power given to the Inland Revenue in 1940[4] enables them to disallow any deductions (such as depreciation allowances) which do not appear to be attributable to the accounting period under consideration.

Section 32, the whole of which is a 1940 innovation, contains an additional clause, which almost appears to be an afterthought, disallowing directors' remuneration in any period, when it appears to be unreasonable in relation to the work performed. It is again very difficult to imagine how this will be enforced, but it is the only section which deals with the general problem of directors' remuneration. The original Act contained a section dealing only with the most pressing part of the problem—the question of directors' remuneration in director-controlled companies. Special

[1] The final allowance will be fixed 'at such date as Parliament may determine', or on the occasion of the sale of the equipment, if it is disposed of at less than cost price.

[2] In F.A. 1941 the terms of allowance were drawn somewhat tighter, and war damage compensation is expressly deductible (section 38).

[3] A further depreciation concession introduced in 1940 is the extension of the right of local authorities to deduct statutory sinking funds (which was taken over from E P.D.) to other public utility concerns having similar obligations and no equity capital.

[4] F.A. 1940 (I), section 33 (2).

provision is clearly necessary to prevent the transmutation of profits into directors' fees in such concerns, but the 1939 section was evidently not considered satisfactory. It was repealed and re-drafted in 1940. The present section disallows the deduction of directors' remuneration in computing both taxable and standard profits (the latter where the profits standard is used). That is to say, directors can only be given additional remuneration at the expense of other shareholders.[1]

These additional safeguards may do something to strengthen the hands of the administration. But in the nature of the case, if prices were to rise sharply, they could be no more check on wasteful expenditure than the corresponding provisions of E.P.D.

E.P.D. only succeeded in stopping artificial sales of assets such as ships and stocks of whisky in a makeshift and empirical manner. E.P.T. employs two sorts of weapons. In the first place a clause prohibiting artificial transactions of all kinds is taken over from E.P.D. Second, and more important, are the limitations imposed where a succession or amalgamation takes place. The general principle is laid down that a change of ownership of the whole or part of a business constitutes a succession and a new business.[2] The standard has to be determined afresh. But this principle is more interesting in the breach than in the observance. Where the change of ownership occurs after 1 April 1939 (the date of commencement of liability), it is, in fact, to be treated as if it had not occurred. The standard and allowances will be transferred intact, and no additional allowances can be claimed on the grounds of the transfer. Any consideration given as part of the change will be disregarded in computing the capital employed.[3] This provision is really a generalization of the solution reached for

[1] The distinction for remuneration purposes between director-controlled and other companies was also made in E.P.D., partly by specific direction of the Act for percentage standard cases (F.A. 1916, section 49), and in other cases administratively under the general power of the commissioners for disallowances of increase. Increases appear to have been uniformly refused in controlled firms. In other companies they were only allowed in exceptional cases, and then with a fixed maximum per director. It is doubtful whether the greater precision of F.A. 1940, section 32, actually confers greater powers, see above, p. 77.

[2] Another set of clauses, more concerned with equity than with economics, provides that in certain cases an old business shall not lose its right of choice of standard by reason of a change taking place before 1 April 1939.

[3] The whole arrangement assumes, of course, that the business is transferred as a going concern.

shipping firms in the last war (a much more sensible solution than the one arrived at for the case of whisky).[1] It should effectively limit the attractiveness of this type of artificial transaction, although it hardly seems to cover the whole problem.[2]

Another device which led to an unascertainable amount of evasion of E.P.D. was the concealment of profits through inter-company transactions among a group. Since then company relations have become immensely more complicated. This is reflected by the appearance in the Finance Act of 1940 of two sections and an explanatory schedule of forty pages dealing with the ascertainment of the liability of groups of companies to E.P.T. The intention is that where companies are closely connected[3] they must be treated as a single concern, both in respect of capital and profits. The group will therefore be deemed to have started at the earliest moment at which any member was in operation. Further it will be deemed to be the same group, and its arrangements with the Inland Revenue cannot be upset within a period in which it does not undergo major changes.[4] Inter-company payments will thus largely cancel out, and cannot be used to reduce the unseemly profits of constituent members in the period in which they occur. The amalgamation provisions will work in the same direction. While these sections will no doubt cover the case of closely related companies, it is by no means clear that concealment of profits will be prevented in more loosely connected groups.[5]

[1] See above, p. 81. The control and requisitioning of ships at an early stage of the present war in any case ensures that astronomical shipping profits will not be repeated. Section 35 of F.A 1941 conferred additional powers of disallowance on the Commissioners where attempted evasion is suspected.

[2] A related form of evasion for E.P.D. was the acquisition of a concern which had done well before the war, but had since fallen on evil days, in order to increase the standard and lower the profits The section on amalgamations in E.P.T. provides that both profits and standard revenue will be completely merged, so that it will only be possible to play this game to a limited extent.

[3] The criterion—that the principal company should hold nine-tenths of the shares of subsidiaries—implies a much closer relationship than that recognized by company law. The reason for this is obscure.

[4] i.e not greater than that implied in the loss or addition of a small subsidiary. A period of this type is designated a Relevant Period.

[5] The concentration of industry for war purposes has given rise to new problems of inter-company relations This is recognized by section 37 of F.A. 1941, where it is provided that (i) cessation of activity as a result of war concentration shall not constitute a discontinuance of business, (ii) payments from one firm to another on account of concentration shall be treated as a deduction from profits for the paying firm, and as a trading receipt by the payee, and (iii) idle plant shall be deemed to have earned normal wear and tear allowances.

In the last resort the extent of evasion depends on how strongly business men want to evade. This, and indeed the whole working of an excess profits tax, depends to a very important degree on the rate at which the tax is levied. The evidence of E.P.D. is unambiguous on this point. Financial experts, revenue authorities, and business men agreed that the high rates levied in 1917–18 had a disastrous effect.[1] Yet little attention was paid to the writing on the wall. E.P.T. started life fairly moderately at 60 per cent. But scarcely six months after it had been introduced the rate was suddenly pushed up to 100 per cent., beginning with the second year of liability.[2] Even in the worst straits of the last war E.P.D. did not rise above 80 per cent., in spite of political pressure, which was at least as strong as in the spring of 1940, and in spite of the fact that there was in office at the time a chancellor who was inclined to put political expediency before financial or economic considerations.[3]

The transition to the 100 per cent. rate was made at a time of great national crisis. It represented an enormous increase in the burden of the tax. It is not surprising that after this drastic tightening up, further amendments have all been in the nature of concessions and reliefs. This development is exactly parallel to the later stages of E.P.D., after the 80 per cent. rate had been imposed. In the budget of 1941 two substantial alterations were made in the basis of the tax. In the first place, breaking with the tradition of E.P.D., borrowed money was included in the capital computation.[4] Secondly, a small measure of relief from the 100 per cent. rate was given by the provision that 20 per cent. of tax paid might under certain conditions be treated as deferred profits, to be refunded after the war.[5] Let us examine in turn the significance of these changes.

[1] Cf. Haig, *passim*, especially p. 150, and the Report of the Committee on Financial Risks, see above, p. 84

[2] It will be recalled that the 100 per cent. rate of E.P T. was introduced in a manner so strange as to indicate either severe divergence of opinion in the government, or a vacillating policy. The change was first announced in May 1940 by Mr. Attlee on behalf of the War Cabinet, but in a manner so ambiguous that it was quite uncertain whether it would apply only to armament firms or to the whole field of industry. It was some time before the Chancellor announced that it was to apply generally.

[3] This at least appears to have been the opinion of Lord Stamp, op. cit., p. 108.

[4] F.A. 1941, section 29.

[5] Ibid., section 28.

It has been recorded[1] that in the later stages of the last war there were serious misgivings as to the wisdom of excluding borrowed money from capital, on account of the hindrance which it imposed on necessary new investment. To realize the restrictive effect on the war industries of the exclusion of borrowed money from capital, it must be borne in mind that war orders are by no means necessarily advantageous to a firm. They entail working new and difficult processes and overworking established staff and existing equipment. They lead to no new contacts and they offer no long period reward for the greatly increased effort. And it is just on the margin of effort that the weight of the tax falls. If debt is excluded from the capital computation firms are naturally reluctant to borrow for the necessary new equipment. At the same time the amount of new investment that can be financed from reserves is strictly limited. Dividends can be reduced to some extent, but a firm which habitually passes its dividend will be putting itself in a relatively worse position after the war than its rivals. And as the war goes on and prices rise, E.P.T. progressively confiscates what additional reserves remain.

In these circumstances necessary expansion can only be achieved by the government directly financing a large part of the new plant and equipment itself. In fact from the beginning of the rearmament phase onwards, this method has been far more widely used than in the last war. It has the advantage that no trouble can arise over the determination of the depreciation allowance, since the government assumes full responsibility. Against this must be set the increased cost of financing the expansion, especially where the 'cost plus' basis is used; and probably also considerable extra delay, owing to the fact that full advantage cannot be taken of normal trade channels and connexions. These are grave community losses, but for the firm itself government financing brings no small advantages. Besides the removal of depreciation responsibilities it is likely to be able to pick up a good bargain in partly used machinery at the end of the war—installed moreover on its own premises.

On the other hand, to include borrowed money in the capital computation, as has now been done, unavoidably restores the general incentive to invest, not merely in the war industries. If sufficient check on new investment by other means is not forth-

[1] Haig, op. cit., p. 83

coming, there is a danger that the restored incentive in non-essential industries may seriously impede the war effort. Presumably in 1941 it was concluded that this danger was less pressing than the proved inconveniences of other methods of securing the adequate expansion of the war industries.

A scheme for deferred profits was also discussed in connexion with E.P.D.[1] As soon as the implications of the 100 per cent. rate of E.P.T. were realized, the suggestion was revived and was widely canvassed. Its introduction therefore occasioned little surprise. As laid down by the Finance Act, 1941, the scheme was of very limited scope. The returnable profits cannot exceed the difference between the tax payments actually made in respect of E.P.T. and N.D.C., and the tax that would have been due if the former had been levied at 80 per cent. instead of 100 per cent. The return was only to be made at such date, and on such conditions as 'Parliament may hereafter determine'. It was thus a concession of too remote and incalculable value to enter into accounting estimates. In 1942 it was therefore found necessary to announce that the return would be a statutory right.

Thus the first two years of E.P.T. witnessed some very striking changes—on the one hand the imposition of the penal rate of 100 per cent., on the other a number of relaxations. Some of these were more or less directly consequent on the altered character of the tax, but others merely registered the impossibility of upholding the inflexible simplicity of the original draft. In the next chapter we shall have to consider more fully the implications of the 100 per cent. rate, especially if it is retained without substantial modifications throughout the war period. Apart from this major consideration, it does appear that the amendments of 1940 and 1941 were definite improvements. The most serious hard cases have been relieved, and provision has been made for the restoration of some incentive. Yet we believe that even within the present framework of the legislation there remain several particulars in which a change might still improve the working of the tax, both in present conditions, and more particularly in case of a serious price rise—for it must always be remembered that a price rise still remains an urgent possibility, if not during,

[1] See above, p. 84.

at least after the war, notwithstanding the additional controls on spending and investing introduced in 1940 and after.

No tax is ever completely equitable between different classes of taxpayers, and with an onerous tax such as E.P.T. it becomes of real importance to see that inequities do not lead on the one hand to serious injustice, or on the other to economic restriction of the war effort. We have seen that excess profits taxes tend specially to penalize the small firm.[1] It is important to keep this in mind, because in a war economy the small firm is also at a disadvantage in several other ways. It is, for instance, less favourably placed for acquiring stocks of scarce commodities than the large firm with wide connexions, and it is often less suitable for the receipt of government contracts. There is, therefore, on grounds of equity as well of administrative convenience, a strong argument for keeping the number of firms liable to tax within bounds.[2] One of the ways of doing this is by a generous exemption limit. The provisions of E.P.T. on this point are an improvement over those of E.P.D. The 'Minimum Standard' gives a higher and more flexible exemption limit (depending ultimately on the size of the firm as expressed by the number of working directors).[3] This applies relief where it is most needed, to the small firm where incentive is most directly thwarted by the confiscation of profits and which has a relatively inadequate cushion of reserves. The principle of the minimum standard is admirable; but it will be important to see that if prices rise the base of the exemption is raised proportionately. (This was done—but only tardily—in the case of E.P.D.[4])

The generosity of E.P.T. with respect to the minimum standard is unfortunately offset by its harshness with respect to the choice of Standard Period. The standard period of E.P.D. was chosen so as to make it a tax on profits which were in excess of those earned during peace-time in a year of good trade; that of E.P.T. is devised to tax profits in excess of the peace-time *normal*. It is not clear that there is any good reason for adopting so rigorous an interpretation of war profits; it must extend very considerably the number of firms who become liable to the tax. To shape the standard period on the E.P.D. model (which would mean making it possible to take the average of 1937–8 as the standard period)

[1] See above, p. 60. [2] See above, p. 46. [3] See above, p 95.
[4] See above, p. 80.

would be very expensive; there is, however, a good deal to be said for a more moderate concession, such as allowing the average of any three out of the four years 1935–8. (It should be remembered that profits declared in 1938 were largely made in 1937, so that there can have been very few cases in which they were profits of rearmament, or anticipatory war profits.)

The early working of E.P.T. brought to light three particular types of hard cases, upon all of which we have previously noted that E.P.T. is markedly less generous than E.P.D. These were the firm with wasting assets, the firm which has a poor profit basis because it possessed an abnormal amount of immature capital in the base period, and the firm in an industry with habitually fluctuating profits. Have these difficulties been sufficiently met by subsequent legislation.

The wasting asset case appears to have been adequately dealt with by the Finance Act 1941. The new arrangement is a definite improvement on the E.P.D. method for three reasons. It limits the special relief to those industries (metal and oil extraction) where over-exploitation due to the war is most likely to cause real hardship. It cannot plausibly be argued that coal mining is in this position, still more doubtful is the claim that agricultural products such as rubber have a right to inclusion. Natural products, capable of extension by improved cultivation and breeding, are in a very different position from metal deposits. Secondly, the relief in E.P.T. is apportioned strictly in accordance with the expected life of the asset, being highest where the life is shortest, and consequently the amount of dividends, which are in fact repayment of capital, is greatest. Thirdly, the relief is confined strictly to the question of premature exhaustion; other irrelevant questions, such as exceptional risk, which clearly found a place in the E.P.D. decisions of the Board of Referees, are now cut out. It would appear that as far as wasting assets are concerned, all that is necessary can now be done.

Turning now to the case of immature capital, a quite new firm comes of course under a percentage standard, which has been set fairly generously, and is applicable to any firm started after 1st July 1936—more than three years before the beginning of the war. It was no doubt thought that by setting this date so early the whole problem of immature investment would become capable of being dealt with under this provision—but it is doubtful if that

is the case. E.P.D. provided for special arrangements to meet hard cases owing to immature investments started before the commencing date for new firms—the large amount of capital which had been invested in rubber plantations just before 1914 being the main case in point. The relevant case for E.P.T. has a closer connexion with the war effort. During the year 1935 a considerable amount of new capital was invested in the manufacture of aircraft, aircraft accessories, and machine tools.[1] By 1936–7 (the latest standard period at present possible) this capital had not always had time to work up to a full level of profitability. If nothing is done to adjust the standard period, there would seem to be a good case for making it possible for such firms to come under the Substituted Standard[2]—as it is not clear that they can do so under present arrangements.

The provision introduced in 1941 whereby in certain cases previous losses can be added to capital employed appears in part to be an attempt to give more relief in respect of immature investment, in part to give further help to the depressed firm. For the former purpose it would perhaps have been more effective to have relieved the immature investment directly, as was done in E.P.D. This would have ensured the eligibility of older firms with abnormal amounts of new investment. Under the present arrangement it would appear that they can only be relieved if they can qualify as depressed firms under the Substituted Standard. The new arrangement is a step, although only a small one, in the High Profits direction, and as such is undesirable.[3] It does not appear that it will be of much use for relieving deserving hard cases in industries with normally fluctuating profits, whereas for firms in depressed industries it is doubtful if additional relief was necessary. It is no part of the work of an excess profits tax to stay the progress of natural industrial decline.

Speaking generally, however, there is no doubt that the smooth and equitable working of E.P.T. requires fairly generous relief for hard cases—both those which are already evident, and have consequently received some attention, and those which may subsequently reveal themselves. A certain generosity is desirable both because of the greater burden of ordinary taxation that has to be borne contemporaneously—relatively to E.P.D.—and because the

[1] New issues on the stock exchange alone totalled £6·3 millions for this group.
[2] See above, p. 96.
[3] See above, p. 40.

general outlook of E.P.T. is more uncompromising than that of E.P.D. This is very largely because the new tax attempts greater precision. In itself this is by no means to be regretted. Broadly speaking, the greater the precision the greater the administrative equity. But just because its operation is less flexible, E.P.T. requires more careful adjustment to exceptional cases.

We now turn to a point of wider application which, originating in a technical detail of the method adopted for the computation of capital, has become of first-rate importance with the imposition of the 100 per cent. rate. Owing to the fact that investments are excluded from capital it will generally pay a firm to avoid carrying its assets in liquid form such as war loan.[1] It will thus pay a firm to employ its free reserves (or to sell securities and employ them) in piling up working capital and raw materials so far as it can get hold of them.[2] Under 100 per cent. E.P.T. the profit on this transaction is independent of any return that may be realized on the new working capital. It depends solely on the yield of the securities and on the percentage allowance for additional capital. This allowance is now 8 per cent. so that it will always pay a firm to sell investments and use the capital in its business, if the investments are yielding less than 8 per cent.[3]

The incentive for piling up working capital is probably greater under E.P.T. than under E.P.D., quite apart from the effect of the 100 per cent. rate, because the difference between the allowance for additional capital and the yield of investments is greater than it was, at least in the early days of E.P.D. It may be argued that the incentive to pile up stocks is actually useful from the community point of view since scattered stocks are less vulnerable to air attack, and once they have been distributed there is a saving of a transport at a time when it may well be more difficult. These arguments hold only in the early stages of a war, or during severe air raids. At a later stage, when stocks of all kinds have been brought very low, their chance dispersion is more likely to prove uneconomic. The position in respect to the housewife's stocks of food is an apt illustration of the way in which conditions change in this respect. At one stage she was being urged by the Minister

[1] Or even cash if the intention of disallowing it is carried out.

[2] See above, p. 51.

[3] Economists will realize that this is equivalent to making the marginal efficiency of capital (artificially) equal to 8 per cent.

of Food to accumulate emergency rations. At a later point he was threatening to inspect her stores. The difference was due at least as much to the change in the supply situation as to the excessive zeal of the housewife.

The obvious remedy for this accidental misfortune of the 100 per cent. rate is quite simple. The incentive for avoiding liquidity would be much reduced if the allowance for additional capital employed were brought down as close as possible to the yield of industrial investments. There is no reason why this change should affect the percentage standard for new firms: the two types of investment are quite distinct It would not be feasible to set the allowance for additional capital as low as the return on gilt-edged. But it would be quite possible to include war loan in the capital computation, and the interest on it in profits. This would have little effect on revenue. Besides further reducing the incentive to lay in unnecessary stocks of working capital this change would directly encourage the buying of war loan—in itself a very desirable end.

The decision announced by the Chancellor of the Exchequer in December 1941 to issue a new type of government debt (Tax Reserve Certificates) for the temporary investment of tax quotas in advance of liability, or pending its ascertainment, touches closely on this point. Ostensibly the new security is intended to reduce excess liquidity (of the banks quite as much as of firms) rather than to secure it. But excess liquidity is only dangerous because it is a temptation to lend or to invest. In the later stages of E.P.D. the tendency to invest tax quotas became very marked, notwithstanding that interest was allowed on prepayments, although no tangible tax certificates were issued. The terms of the new Certificates are not in themselves very attractive.[1] The 1 per cent. (tax free) interest allowed presents little if any gain on the $2\frac{1}{2}$ per cent. discount previously allowed on income tax (Schedule D) prepayments. So long as the most attractive alternative to buying tax certificates is leaving funds on deposit at the bank, the new security should serve its immediate purpose. But if other obstacles to investment are not firmly maintained, circumstances may well arise in which the oppor-

[1] Although in some financial circles they were criticized as being over-generous (cf. *Economist*, Dec. 1941). Judgement depends on what is regarded as the ultimate purpose of the issue.

tunity of buying tax certificates will not necessarily ensure that a liquid balance is always waiting for the tax collector. Even if this is achieved it touches only the fringe of the general problem of the excess liquidity of firms, since as stocks run down tax quotas come to represent a progressively less important part of total liquid assets.

The importance of these latter considerations lies mainly in the future, in the difficult period immediately after the close of the war. No one who reads carefully the provisions of E.P.T., particularly with its 1940 and 1941 amendments, can doubt that it is a very powerful and a very skilful tax for current war purposes. But its onerousness must never be forgotten. The severity of 100 per cent. E.P.T. over the whole field of industry is not realized unless the effects of a 10*s*. income tax and of the N.D.C. alternative are constantly kept in mind. The combined effect is that a firm cannot now under any circumstances retain more than two-thirds of its pre-war profits. From income tax there is no escape. Although N.D.C. is not paid when the taxable excess represents more than 5 per cent. of total profits, it may add to the disturbing effects of E.P.T. in more than one way. Although only one of the two taxes will eventually be paid, the double calculation has always to be made—which causes additional delay and trouble in assessment. Further, N.D.C. will be deducted from any refund made on the suspense accounting principle. This additional levy on reserves in lean years diminishes the cushion against further exactions. And as prices go up income tax and N.D.C., like E.P.T., take an increasing toll in real terms.

CHAPTER XII

HUNDRED PER CENT. E.P.T.

THE main *economic* purpose of an excess profits tax is to absorb funds which would otherwise either compete directly with the war effort by being applied to other investment, or would tend to raise the prices of consumers' goods by being distributed in dividends and spent by the receivers. E.P.T. at 100 per cent. performs this service very efficiently. But this is not all that is wanted. An excess profits tax will inevitably bear more hardly on some industries and firms than on others, hence it will tend to promote contraction in some directions, expansion in others. It will diminish incentive in some places, it may tend to increase it in others. It is very desirable that these influences should be in the direction required by the war effort, and not opposed to it.

As already pointed out, the really dangerous thing about a 100 per cent. tax is not so much that it removes the incentive to make profits, but that there is no adequate inducement to avoid losses.[1] This has different implications for different types of firm. The inefficient ones will just get into evil ways, and these may be difficult to eradicate later. The well-managed and far-seeing firm will not lose its efficiency, but will tend to transfer its energies from the present, when its extra exertions do it no good, to the future, when it will once more be free to retain its profits. The most obvious ways of doing this, by wage and trade concessions, are well known, but they cannot be wholly guarded against, either by legislation or by administrative care. Such transfer is disadvantageous to the community wherever it occurs. It is perhaps most likely to be conspicuous in the industries not directly connected with the war effort, since they are working at less pressure in respect of present output and are less subject to control than the war industries proper. It is especially undesirable because it tends to offset some of the control of consumption exercised by income limitation. Planning for a future which cannot be foreseen with any accuracy is largely waste of time in any case, quite apart from the extent to which it hinders the war effort.

[1] See above, p. 77.

In respect of the war effort industry may roughly be divided into three classes: (i) the war industries proper whose expansion is an urgent necessity; (ii) the other essential industries whose most important task is to maintain output as efficiently as possible, in spite of the fact that they may frequently have to work with inferior labour and materials; and (iii) the non-essential industries who also serve—but by contracting gracefully. What effect is 100 per cent E.P.T. likely to have on these three classes of industry?

In the first place it must be remembered that E.P.T. can have little or no effect until the standard profit is exceeded. Thus its general effect only becomes serious when the standard profit is exceeded over a large part of the industrial field. The contracting group were clearly not affected at all in the early stages of the war. It is only when prices have risen sufficiently for additional money profits to be earnable on a reduced real turnover that E.P.T. can influence them. Owing to the recession of the early months of 1937, it is in fact probable that a much larger part of the industrial field was only slightly affected by E.P.T. in the first two years of the war. According to an estimate made by the *Economist* in the autumn of 1939[1] there was room for an all-over increase of some 10 per cent. on 1938 profits before the critical point would be reached. A later calculation confirmed this.[2] Only in the iron and steel and engineering groups were profits either in 1938 or in 1939 substantially above the standard, and in all these cases 1939 profits were below 1938. The general effect of E.P.T. in 1940 can therefore only have been moderate. But it is a sobering thought that in the vital war industries the point where good management and efficiency cease to be worth while had already been passed by the time of the announcement of the 100 per cent. rate. On the other hand, by the end of 1940, or at latest in 1941, the greater part of the industrial field must have come within the range of E.P.T. Consequently all the tendencies in the tax which make for inefficiency, unnecessary expenditure,

[1] *Economist*, 7 Oct. 1939.

[2] Cf. ibid , 9 Nov. 1940. The figures may be somewhat misleading since in some cases provision for tax liability had already been deducted Company reports issued in the second half of 1940 suggest that it has been the practice to make very generous tax provision—partly, no doubt, because the precise working of the allowance could not be foreseen, and partly, perhaps, with a view to protecting reserves against the demands of shareholders. This qualification, however, does not detract from the main conclusion.

or slackness of management probably began to exert their influence at that time.

The position was not so serious in the case of the munitions levy, the 100 per cent. tax of the last war, since the levy was confined to controlled firms. The authorities ought to have had some chance of preventing waste when they had only 4,000 firms to deal with, and could fully examine the books and inquire into costs in detail. But the incredible delay in determining liability was the main cause of the breakdown of the levy. In the case of E.P.T. the new disallowances for improper expenditure introduced in 1940 may have done something to strengthen the hands of the authorities. Another advantage is that from the beginning of E.P.T. the Inland Revenue have had the whole tax in their own hands. Moreover, they can now call on a greatly expanded specialist staff. But it is hardly conceivable that costs can be thoroughly examined over the whole field of industry, and the detailed provisions of E.P.T. strictly enforced, without giving rise to at least as great arrears as occurred with E.P.D.

The main importance of the delay which may be caused by the 100 per cent. rate is after the war. The efficiency aspect is of vital present importance. It is noteworthy that Stamp records a welcome increase of efficiency in the controlled firms merely as the result of restored incentive when the 100 per cent. munitions levy was transmuted into the 80 per cent. E.P.D.[1] But firms liable to the munitions levy had only a relatively low income tax to contend with in addition. During the critical period of expansion it was very low indeed. Thus apart from the exactions of the munitions levy incentive was by no means lacking.

The provision introduced in 1941 for the eventual refund of 20 per cent. of the tax already paid was clearly intended to meet this difficulty. As we have already pointed out[2] the prospect of this refund was too uncertain to be included in industrial calculations, since both the terms and the time of the refund depended only on the fancy of a future Parliament.

The conditions under which blocked profits should be released is a matter which requires very careful consideration. Clearly it is not possible both to give firms a guarantee of return, and to allow them to choose the moment when the refund will be available, without jeopardizing financial and economic planning in the

[1] Stamp, op. cit., p. 110. [2] See above, p. 104.

immediate post-war period. If the release is to have favourable economic repercussions it must be very carefully timed, so as to coincide with the end rather than with the beginning of the inevitable post-war restocking boom. The Committee on Financial Risks, which put forward a scheme for conditional blocking of profits in 1918[1] intended that the refund for each firm should depend on its trading experience in the first five post-war years. This was not a very good plan. It would have been arbitrary, and it would have been difficult to prevent the prospect of a refund from diminishing the incentive to good management in the critical years. There was no reason why the Treasury should surrender the right of advising on the time of release. It would be both simpler and more useful to make the *time* of release depend on some general criterion, such as the level of employment,[2] while making the *right* to a refund as definite as possible. It is to be hoped that the statutory right to refund promised by the Chancellor of the Exchequer in the Budget of 1942 will allow of such an arrangement in the post-war period.

If the concessions of 1942 do not prove to be sufficient to restore the incentive both for increased production and for economical management, it may be necessary to take further measures. The simplest and surest method would be to lower the current rate of E.P.T. by 10 per cent.—or even 20 per cent. This would meet the case of those firms which are now handicapped by increasing illiquidity. Taken together with the 20 per cent. deferred repayment, this should be quite sufficient to restore incentive generally, since during the war period we can count on strong patriotic motives being in operation. Since, however, part of the excess profits would be available for distribution to shareholders this plan would naturally not be as effective as complete confiscation in preventing the appearance of the war profiteer. In order to combat him, two courses are open. Either a dividend limitation measure could be revived, or his emergence could be forestalled by an additional tax on the expansion of personal incomes—an excess income tax. Of the two alternatives the latter seems preferable. Dividend limitation inevitably involves arbitrary elements, depending both on the past distribution policy of the firm, and on its capital structure. It might also tend in certain

[1] See above, pp. 83 ff.

[2] For further discussion of this point, see below, p. 117*a*.

cases to foster a degree of liquidity which would only add a further complication at the end of the war.

We have seen that an excess income tax in conjunction with an 100 per cent. excess profits tax would not be worth while.[1] Most of the revenue would have to come from salaries and professional fees, and it is very doubtful if it would cover the cost of collection. But the case for a drastic excess income tax in company with a moderate excess profits tax is very much stronger, in fact it is very strong indeed. The lowered rate of excess profits tax would give the business man an incentive to make profits to add to his reserves, while he would still not be able to make excessive profits. So long as there was no absolute stop on dividends he would be able to add to his goodwill with shareholders by distributing some of these additional profits. The excess income tax would ensure that substantial net gains did not accrue to particular individuals.

There would be every argument for making the rates of the excess income tax quite confiscatory, at least on the higher incomes. To have its maximum effect the tax should probably be graded both according to total income, and according to the percentage of the excess over the standard income. Arranged in this way an excess income tax would collect more of the real war gains than an excess profits tax alone would do. Administratively it should not be very formidable since, as we have seen,[2] on practical grounds it would have to be limited to the pre-war income tax paying income groups, for whom there is good evidence of standard incomes. Although there would probably be some loss of revenue under the combined arrangement as compared with a simple 100 per cent. excess profits tax, there would be offsetting advantages. The abolition of penal rates of E.P.T. would diminish the incentive for evasion, and the increase in business efficiency would tend to reduce costs, and hence government expenditure.

The triple plan of an E.P.T. with a slice of free profits and a slice of blocked profits, together with an excess income tax to look after the war profiteer would remove the main disadvantages of E.P.T. during the war. But the end of war problem is at least as serious and not so easily disposed of. With rising prices nothing can prevent a high rate of excess profits tax from gradually confiscating industrial capital. At the end of the war a serious renewal problem in respect of fixed capital inevitably presents itself, and

[1] See above, pp. 68 ff. [2] See above, p. 66.

at the same time many firms will be short of working capital, especially in respect of those commodities which have been in short supply during the war. Since the high rate of tax will already have swallowed up the reserves out of which this restocking would naturally be financed, some other method will have to be found. This means that there is likely to be an orgy of borrowing, both from the banks and on the stock exchange, the moment the war is over and controls are removed. As there is bound to be a considerable overlap between the final war needs of the government and the initial peace needs of industry, boom conditions are very likely to arise. At the same time it is clearly undesirable to restrict the genuine needs of industry, for instance by imposing punitive interest rates.[1] If in these circumstances no significant price fall subsequently occurs, the worst that will have happened is that the government may have some difficulty in renewing its short-term borrowing, and some firms will be unable to avoid entering the post-war period with uncomfortably high-geared capital structures. But if a substantial price fall does take place the situation will be very much worse. Firms will be unable to realize a normal return on their reinvestment, and in many cases they will make actual losses. And it is hard to conceive of a post-war situation in which there will not be some degree of price fall within two or three years—if only because of the difficulty of maintaining the pace of restocking and re-equipment.

It will be recalled that the method by which E.P.D. coped with this situation was far from satisfactory.[2] In the first place a number of rather limited concessions were introduced in respect of the valuation of stock held at the close of the tax. These were accompanied by an allowance for postponed repairs and renewals intended to compensate for the deterioration of fixed capital. In practice it proved impossible to distinguish satisfactorily between necessary and unnecessary repairs, and in many cases the allowance was generous to a quite uncalled-for degree.[3] But far more important than any other concession were the refunds which accrued to firms under the suspense accounting principle, owing to the fact that E.P.D. was continued in operation over the slump as well as over the boom.

[1] See above, pp. 18–19.

[2] See above, pp 85 ff.

[3] On the other hand, the stock concessions were considered to be insufficient; see above, p. 84.

It must be clearly recognized that it will not be possible to repeat this pseudo-solution at the end of E.P.T., especially if a high rate of tax is left in operation. The amount of evasion which would take place makes it inconceivable that a 100 per cent. rate could be kept on for even a short period after the war. If an attempt was made to keep the tax on for some time in order to control the boom and then remove it so that there would be no refund, industry would be left in a perilous position. However, even if it were possible to repeat the sequence of events of 1919–21, it would be very undesirable to do so. It is only necessary to reflect on the expense and disturbance involved in assessing an enormous revenue only to remit it the following year, in order to condemn this method.

As things turned out, the stocks problem at the end of E.P.D. was less serious than had been expected. The worst fears of industry were grounded on the belief that prices would immediately sink back to their pre-war level, and they did no such thing. Are there any reasons for hoping that the situation might be still less serious in this respect at the end of E.P.T.? We believe that there are, and that this is to some extent independent of the precise outcome of the war, because it arises from the advance in the technique of monetary management which has recently been made. This is both an internal and an international matter, and is not the monopoly of big and powerful nations, although naturally some countries have been more successful than others. New methods of monetary control have been practised and experience in them gained, both by the free countries following the Tripartite Agreement and the sterling bloc, and by those which have adopted German methods. It is important to observe that the international technique is closely linked up with the internal control of the supply of money, and hence of interest rates, and hence, indirectly at least, of prices. The British technique of exchange management, and internal money market control through the funds of the Exchange Account, illustrates this interrelation clearly, but there are other ways of achieving the same ends.

Not all the new machinery works without creaking, not all the new devices are desirable precedents for the freer world which we hope to see arising after the war. But they do provide a reasonable expectation, first that neither we nor other people need flounder in the morass of purely monetary chaos which so much retarded recovery after the last war, and secondly that we shall

have some more say in fixing the equilibrium of prices in the post-war world, instead of having it for the most part thrust upon us by force of circumstances. It is not possible or desirable to forecast at this stage what the precise optimum level of prices should be. A natural assumption would be something below the war peak, but much nearer to it than to the pre-war level.

If prices are shifted up in this way, some of the end-of-war problems of E.P.T. will be materially lightened. There will be less fear of grave losses on reinvestment. Consequently there would be less danger in frenzied borrowing. Nevertheless, it would still be desirable to restrict the need for borrowing as much as possible, both in view of the government's end-of-war requirements and of the fact that firms have not equal access to the capital market. In this connexion it is very desirable to keep in mind the difficulties of the small firm, which, as we have seen,[1] suffers badly from excess profits taxes in any case. An urgent need of refinancing after the war could only leave the small firms heavily indebted to the banks, a most undesirable outcome in every way.

One method of cutting down the need for post-war borrowing might be found along the lines of the E.P.D. concessions for stock and renewals. This would not be a very good solution since such allowances are difficult to determine with impartiality. This difficulty provides an additional argument for freeing completely from tax a proportion of excess profits. The Committee on Financial Risks were confident that with a 60 per cent. rate the trouble would never have arisen.[2] With a 60 per cent. tax plus 20 per cent. deferred profits it would be very much eased.

This is the point at which the control of the time of the release of the blocked profits becomes important. Everything that strengthens control in the immediate post-war scramble is useful. The time-lag which occurs between the making of profits and the collection of tax revenue implies that in the first post-war year at least much tax will still remain to be collected, even if there is no serious volume of arrears. If the tax-cum-block is at a high level the control thus exercised should be considerable. In the succeeding period there would be open to the financial authorities not merely the possibility of stimulating recovery by tax remission, but also the power of releasing the blocked profits rapidly or gradually according to the economic situation.

[1] See above, esp. pp. 43, 60. [2] See above, p. 84.

The lowering of the rate of E.P.T. now, together with an extension of the scheme of deferred profits, would thus materially ease the end-of-war problem and the closing of the tax, as well as the current war problem. But there is still the question of the remaining portion of the excess. If the suggested policy of leaving a modicum of profits entirely free were adopted it would undoubtedly leave some, although not a very large, opportunity for the realization of additional incomes. It is unlikely that an excess income tax would be so successful as a 100 per cent. excess profits tax—or 100 per cent. tax-cum-block in preventing the emergence of the war profiteer. The problem would become more pressing if in addition it was decided to fix post-war prices on a relatively high level. There would then be not merely an increase of wealth as the result of a succession of higher incomes, but a substantial bettering of the position of all ordinary shareholders on capital account, relatively to other classes in the community.

After the last war the increase of wealth in certain private hands, notwithstanding the fall in capital values due to the rise in the rate of interest, was so notorious that a capital levy on war wealth was very seriously considered. After the present war, assuming that interest rates continue low, there will be less offsetting by capital losses. On the other hand, the opportunities for the profiteer over the whole period of the war will no doubt be very much less than they were in 1914–18. Many of the most conspicuous profiteers arose in the first two years of the war before controls (e.g. of milling and shipping) had been established, and when E.P.D. was only feeling its way. Nevertheless, it may well be that sufficient incentive for war-time efficiency can only be obtained by allowing some people besides the wage-earners to increase their wealth.

If at the end of the war the war-wealth problem seems to require action, on social if not on economic grounds, there are several ways in which it could be tackled. One method would be to continue the excess income tax for a term of years. The difficulty about this would be that normal promotion as a cause of rising income could no longer be disregarded. This difficulty would be avoided, but the problem only partly solved, by confining the tax to unearned income. But the fact is that no mere income tax is suitable for dealing with what is essentially a capital problem. We must therefore postpone further discussion until a later stage when we have investigated the ways of capital levies.

PART IV

EXCESS PROFITS TAXES IN OTHER COUNTRIES

CHAPTER XIII

THE AMERICAN EXCESS PROFITS TAX (1917–21)[1]

THE American tax of the last war stands alongside E.P.D. as the other classical excess profits tax; it is the classical tax of what we have called the high profits variety. At the date when it was first imposed the United States had not yet actually engaged in hostilities; this, together with the popular feeling that many of the profits ordinarily earned in their rapidly expanding economy were improperly high, led the Americans to tax, not war profits, but all profits exceeding a certain conventional rate of return on invested capital. In the course of its history many modifications were introduced into the American tax; at times its original principles almost disappeared out of sight. But there were always some significant features which can only be explained by reference to these general principles. The theoretical character of these principles—their theoretical weakness—has been examined in a previous chapter. It will be interesting to see how they worked out in practice.

There are many ways in which the American tax was a striking success. Imposed in a country with hardly any experience of direct taxation by the central (federal) government, it brought in a large revenue, which was an important contribution to the total cost of

[1] No comprehensive history of American taxation during the last war or of the excess profits tax appears to exist. The following account has been mainly put together from the articles on the subject in the various economic journals, which are fairly abundant. In the first place, the series of critical summaries of the Revenue Acts by R. G. and G. C. Blakey (*American Economic Review*, *passim*) provide a useful foundation. In default of the promised book by T. S. Adams (Lord Stamp's opposite number) we have a series of articles by him: 'Principles of Excess Profits Taxation' (*American Academy of Political Science*, *Annals*, 1918), 'Federal Taxes upon Incomes and Excess Profits' (*A.E.R. Supp.* 1918), 'The Future of the Excess Profits Tax' (*A E.R. Supp.* 1920), 'Should the Excess Profits Tax be repealed?' (*Q.J.E.* 1920–1) R. M. Haig's often quoted report on the British tax throws much indirect light upon the American. See also C. C. Plehn, 'War Profits and Excess Profits Taxes' (*A.E.R.* 1920), F. R. Fairchild, 'Federal Taxation of Income and Profits' (*A.E.R. Supp.* 1921), the Report of the American Economic Association Committee on War Finance (*A.E.R. Supp.* 1919), and various articles in the journals by E. R A. Seligman and others.

the war, and did this without imposing any check upon the remarkable progress of American industry. The theoretical weaknesses mainly showed themselves in the form of individual hardships, which were serious. But we must begin by setting out the fiscal background against which these events took place.

The history of American taxation, like that of most American institutions, is profoundly influenced by the constitutional limitation on the powers of the Federal Government. A federal income tax was introduced for the first time in 1913, so that it was not yet working smoothly, and with its low rates[1] it produced only a small fraction of the federal revenue. Most of the revenue came from indirect taxes—excises on tobacco and alcohol, and customs duties. The outbreak of the European war led to a decline in customs revenue; Congress responded by imposing more indirect taxes internally. But in 1916, when the shadow of war was drawing nearer, and appropriations for the Army and Navy had to be increased, there was a change in policy. The emergency indirect taxes were dropped, income tax was raised a little, and several new direct taxes were imposed. We are only concerned with one of these new direct taxes, the Munition Manufacturers' Tax, a 12½ per cent. flat rate levy on net profits. Like the munitions levy in Great Britain, it was the forerunner of the excess profits tax.[2]

In the early months of 1917 war was so close that Congress decided to build up the country's military and naval forces in preparation for the conflict. The financing of these measures (Act of Special Preparedness, 3 March 1917) included a rise in estate duties and an 8 per cent. excess profits tax on the profits of all companies and partnerships which were in excess of 8 per cent. on the capital invested. This, the first excess profits tax, never really operated; in October of the same year it was superseded by a more important enactment which was made retrospective. But it set the tone for what followed.

Not much explanation seems to have been given of the reasons for adopting the high profits principle; March 1917 was no doubt

[1] Income tax 1 per cent. in 1913, raised to 2 per cent. in 1916. Surtax on the highest incomes rose to 6 per cent. in 1913, and to 13 per cent. in 1916.

[2] The M.M. tax was subsequently reduced to 10 per cent., and dropped out after 1917. It was no more of a success than its British counterpart, though it did not have the particular administrative difficulties of the British tax to contend with. The total revenue brought in over two years was no more than $40 millions.

hardly the moment for very profound consideration of a new departure in fiscal policy. There was a precedent for a tax of this kind in the Canadian Act of 1916;[1] it has further to be remembered that those responsible for the provisions were naturally on the look-out for permanent sources of federal revenue (the existing sources being still so scanty), and only the high profits principle seemed to offer the makings of a permanent tax, which could be continued when the war was over. The first real controversy over the principles of the tax came at the next stage.

The United States declared war on 6 April. Serious war finance begins with the Revenue Act of 1917, which passed into law in October. The provisions of this Act were under discussion between the Houses for many months; what finally emerged was a good example of the kind of negotiated compromise which is the usual result of leaving detailed financial decisions in the hands of representative assemblies. It was decided to try to raise 50 per cent. of the cost of the war by taxation;[2] the taxes relied upon were income tax,[3] the alcohol and tobacco duties, and the excess profits tax. Over the excess profits tax there was a decided difference of opinion between the two houses. While the House of Representatives desired to retain the high profits principle which had been incorporated in the March Act (merely proposing to raise the rate of tax from 8 to 16 per cent.), the Senate was impressed by what it had learned of British experience and favoured a war profits tax, in which the profits actually earned before the war were to be taken as standard. The administrative simplicity of the war profits principle (the avoidance of capital computation) was urged in its favour; otherwise the discussion mainly turned on hard cases. The war profits principle could not be used for new firms; it was hard on firms which had been in a depressed condition before the war; the high profits principle, came the rejoinder, is hard on firms which were doing well before the war started, but now find themselves doing no better, perhaps even rather worse.

The precise nature of the compromise which was adopted we shall describe later on. Something of the war profits principle was included, but only as a means of making minor adjustments in

[1] See below, p. 171.

[2] There was, of course, no particular reason for this. In 1918, to cover one-third of war expenditure out of taxation was considered sufficient.

[3] The rate of income tax was now raised to 6 per cent., and the exemptions were thinned out.

the standard percentage; the tax remained in substance a high profits tax. One interesting feature which did lean in the other direction was the extension of the tax to cover excess incomes. Businesses without invested capital were taxed when their earnings became more than \$3,000 above the pre-war level; professional incomes when they became more than \$6,000 above. Otherwise a computation of capital was necessary for all businesses. Very wide discretionary powers had to be given to the Treasury and to the Bureau of Internal Revenue, powers which were quite unprecedented in American legal practice. We shall come to appreciate the extraordinary character of these powers later. For the same deficiencies—deficiencies due in the main to the legislative procedure—persisted to some extent in the Revenue Act of 1918.

The discussions relating to this Act began in May 1918, but it was not finally passed into law until February 1919—by which time the war was over. The original Bill passed by the House had been amended by the Senate on no less than 600 points; but this was hardly suprising in view of the change of circumstances as the negotiations proceeded. It would appear that by 1918 the Senate was making more headway in its advocacy of the war profits principle; if the war had gone on, America might have been converted to a war profits tax on the English model; but the Act which was to have registered the triumph of the war profits principle only passed into law at a time when the taxation of war profits had lost its *raison d'être*. Whence there followed further complications. In 1919 war expenditure was being reduced; but a new fiscal problem was being introduced by prohibition, for duties on alcohol had been an important source of revenue. Revenue from the old indirect taxes was bound to decline; something had to be found to take their place. Here was a new role for the excess profits tax; but since prohibition was to be a permanency, the excess profits tax had to be a permanency. The war profits principle could not provide a permanent tax; so it was undone in the day of its triumph, and Congress turned back to the high profits principle once again.

The main provisions of the '1918' act were these. The excess income tax on professional incomes and businesses without invested capital was dropped. A war profits tax at the rate of 80 per cent. was imposed upon profits earned in the year 1918, but on these only. An excess profits tax on the high profits principle

(falling on profits which were over 8 per cent. on the capital invested) operated concurrently, but so far as 1918 was concerned, it was mostly swamped by the war profits tax. After 1918 it was to come into its own, but the rate of tax, which was sharply raised for the year 1918, was to relapse after that to something like the 1917 level.[1] This was the excess profits tax which lasted until 1921.

Agitation for the repeal of the tax began almost at once. Although the excess profits tax which survived into 1919 was a distinct improvement on its predecessors, it suffered like them from an unfortunate date of birth, and it inherited some of the odium which they had aroused. The Democratic Administration was determined to maintain the principle of relying upon direct taxes, among which the excess profits tax was to be included; but even the President was strongly in favour of modification. Business interests naturally favoured out-and-out repeal; after a while the Treasury experts began to lean the same way. At a meeting of the American Economic Association in December 1919 Professor Adams, the principal Treasury expert, came out strongly against the tax. He maintained that 'it is time to abandon the excess profits tax, not only because it is too complex and discriminatory in its application, but because it is losing its productivity'.[2] The Republican victory of 1920 made repeal inevitable.

When the Senate Finance Committee came to report on the Revenue Act of 1921, it assumed 'that everyone is convinced of the necessity of such a change'. The tax had to be repealed, because 'in practice it exempts the overcapitalised corporation, falls more heavily upon corporations of small or moderate size than upon large corporations, penalises conservative management, and places upon the Bureau of Internal Revenue a task beyond its strength'. Liability ended in December 1921; the only relic which remained after that date was a small increase in the income tax on corporations (raised from 10 to 12½ per cent.).

This replacement of the excess profits tax by an extra income tax

[1] Income tax was raised to 12 per cent. on incomes in excess of $4,000, for the year 1918 only. After 1918 the rates were to be reduced (4 per cent. below and 8 per cent. above this figure).

[2] This statement arose out of a discussion on Professor Haig's report on he working of the British E.P.D. This is the report which has been so useful to us throughout our present inquiry. Its purpose was to assist in framing future American policy. Professor Haig himself favoured modifying the American tax, not repealing it (*A.E.R. Supp.*, Mar. 1920).

on companies was a natural development, because the various revisions of the excess profits tax had tended more and more to make it a pure tax on corporate enterprise.[1] The professional and cognate incomes which had been included in 1917 went out after that date; partnerships were also excluded about the same time. The fact that excess corporate profits were taxed, while profits from partnerships were not, very naturally became a sore point. The distinction between a partnership and a corporation is often no more than a matter of legal form; firms which were liable found that their competitors in the same line of business were escaping. It could be argued on the other side that partnership profits could not lie undistributed, so were subject to surtax, and that this provided a sort of rough justice; but since the two taxes were raised on very different principles, the justice was certainly very rough. The solution by corporate income tax, adopted in 1921, was certainly much fairer from this point of view.

We may now proceed to discuss the detailed provisions. These may be arranged under four heads: (i) structure and rates, (ii) definition of profit or income, (iii) definition of invested capital, (iv) administration. Let us take these in turn.

Structure and rates. As we have seen, the character of the American tax underwent very revolutionary changes during the five years of its imposition. Three phases have to be distinguished: 1917 (Revenue Act, 1917); 1918 (Revenue Act, 1918); and 1919–21 (also imposed in the Revenue Act, 1918).

Throughout all these changes, the underlying principle was that of a tax upon profits which exceeded 8 per cent. on invested capital by more than $3,000. But in the year 1917 there was a slight modification[2] in the standard 8 per cent., and in the year 1918 this

[1] Not all corporations were liable There was a blanket exclusion of all those which were exempt from corporate income tax This mainly excluded a number of charitable and public service bodies, but there was one notable feature on the list, the 'personal service corporation' defined as one 'whose income is to be ascribed primarily to the activities of the principal owners or stockholders, who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital is not a material income-producing factor'. This exemption was, of course, in line with the exemption of professional incomes; it tended to emphasize the purpose of the tax as a tax on the profits of capital. The exemption of gold-mining companies (Revenue Act, 1918) obviously requires a different sort of explanation.

[2] This slight modification consisted of a very limited concession to the war profits principle. Instead of a fixed 8 per cent. on invested capital, the standard

excess profits tax on the high profits principle was overlaid by a substantially quite separate war profits tax on the war profits principle, levied on profits which exceeded those earned in a pre-war standard period (1911–13)[1] by more than the same \$3,000. The excess profits tax and the war profits tax were in operation concurrently, firms being assessed to both and paying whichever was the *higher;* but since the war profits tax was imposed at a much heavier rate, it seems probable that it was most usually the one which was effective. After 1918 the war profits tax came off, and the whole tax reverted to the pure high profits type.

The rates for the excess profits tax (though not for the 1918 war profits tax) were always more or less progressive.

In 1917 there was a complicated scale, rising in fractions. Excess profits out of a total profit which was less than 15 per cent. of the capital invested were taxed at a rate of 20 per cent., and successive fractions at higher rates, reaching 60 per cent. on the excess over 33 per cent.

In 1918 the rates were raised, but the progression simplified. Excess profits out of a total profit which was less than 20 per cent. on capital invested were taxed at a rate of 30 per cent.; the excess over 20 per cent. was taxed at 65 per cent. The rate of the war profits tax, which ran concurrently, was 80 per cent.

In 1919–21 excess profits out of a total profit which was less than 20 per cent. were taxed at 20 per cent., and the excess over 20 per cent. at 40 per cent. Thus the same two brackets were retained but the rates reduced.[2]

So far as the rate of tax is concerned, there can be little doubt that the American excess profits tax was decidedly lighter than the British. During the one year 1918 the two taxes were equally savage; but the 80 per cent. rate, which lasted for two years in

percentage was taken to be the average percentage earned during the standard pre-war period, so long as it was not less than 7 per cent. or more than 9 per cent. Of course, new firms had the usual 8 per cent. standard.

[1] A standard percentage of 10 per cent. was allowed on changes (increases or diminutions) in the amount of invested capital. The same standard percentage was allowed for companies with subnormal profits in the pre-war period. New companies were allowed the rate of profit earned by 'representative concerns' (see below, p. 130), with a minimum of 10 per cent.

[2] In 1918–21 there was also a maximum percentage of the tax to total net profits, designed to protect the small firm. In no case was the tax due to be more than 30 per cent. (1918) and 20 per cent. (1919–21) of total profits in excess of \$3,000, provided the total profits were not more than \$20,000. (The protection extended to the first \$20,000 of larger profits.)

Britain, only lasted for one in America. During the rest of its life the American tax was quite mild; the progressive scale makes calculation difficult, but the tax can rarely have taken away more than 20 to 30 per cent. of excess profits. It is true that excess profits meant something different from what they meant in England; both the definition of taxable profits and the standard from which the excess was measured were different; to the elucidation of these differences we must now turn.

The definition of net profits. The net income of the company was defined in the same way as for income tax: gross income from all sorts of gains and profits, minus a series of deductions. These were: (1) business expenses; (2) interest paid or accrued within the year on the indebtedness of the concern; (3) taxes paid or accrued within the year, excepting income tax and excess profits tax; (4) losses sustained within the year (excluding artificial losses made by repurchasing securities within thirty days); (5) debts ascertained to be worthless and written off within the year; (6) dividends from taxable concerns; (7) a reasonable allowance for depreciation and obsolescence; (8) a special amortization allowance for war production; (9) a reasonable allowance for depletion of certain wasting assets.

This is the formal definition. Apart from the inclusion of investments (which, it should be noticed, was designed in such a way as to avoid double taxation so far as possible), the differences from British practice which need special notice are the following.

First of all, as is well known, the American definition includes capital gains. We should be clear what this means. No country has ever succeeded in imposing an income tax which falls only on income in the strict economic sense—that sum which the taxpayer can spend (or distribute) within the period without eating into his capital. The difference is that the British definition excludes gains made 'outside the ordinary course of trade'; the Americans do not pretend to be able to make such a distinction. When the matter is looked at in this way, the difference in practice becomes very understandable; the 'ordinary course of trade' is a more recognizable thing to an Englishman than to an American. But it is not very recognizable even in England in war-time; we have discussed the way in which the rule had to be modified in order to prevent

certain notorious evasions of E.P.D. (whisky and ships).[1] America was spared these complications; but she did run into difficulties in the other direction, particularly in view of another notable difference from British practice—the absence of any provision for suspense accounting and deficiency payments.

Liability to the American tax was entirely confined within the annual period; every profit was due to be taxed in the year in which it was received, no adjustment being made for subsequent losses, even if they occurred in the following year. This is perhaps the chief way in which the American tax was more rigorous than the British. If the high rates of the war profits tax had lasted more than a single year, or if the inflation during that year had been more rapid, there can be no doubt that the Americans would have been confronted with an even more serious problem of 'trading stocks' than arose in the British case;[2] as it was, the problem did not become acute, and nothing was done about it. Nevertheless, the strictness of the annual period did lead to cases of hardship, and in some of them provision was made to meet it. Income from long-term contracts, which accrued in a single year, though it was earned over several, is a case in point; this was dealt with by a Treasury regulation which permitted apportionment between the years, according to the amounts of labour and materials used.[3] And in certain cases of the sale of capital assets, where the inclusion of capital gains and the strict annual period might combine together to produce intolerable hardship, the general provisions for flexibility, which we shall describe below, might be invoked. The concern in question might be taxed, not according to its own 'profits', but according to the profits of a 'representative concern' in its line of business.

On the matters of depreciation, obsolescence, and wasting assets, the Americans began with an income-tax law which was considerably more generous than the British. British wear-and-tear allowances were confined to machinery and plant, but the Americans permitted an allowance for the depreciation of intangible assets (patents, &c., but not goodwill). Instead of presenting standardized rates of wear-and-tear on the British pattern, the American law

[1] See above, pp 79, 81. [2] See above, p. 82.

[3] The same device as was used in the British case, but it should be noted that the importance of this provision was greater in the framework of the American tax.

allowed the taxpayer to fix his own depreciation allowances, subject only to a general revision by the authorities if they were found to be exorbitant. (Since it is always possible to make a very good case for higher rates of depreciation than would be fixed by an outside body, this represented a very important concession.) Again, British income-tax law gives no allowance for depletion of wasting assets; but the rapid exhaustion of mineral deposits is a very much more important question in America than it is in England, so that the Americans were compelled to give it very careful attention indeed. In the case of 'mines, oil and gas wells, other natural deposits, and timber', a 'reasonable allowance' for capital depletion is given, on the principle that the capital invested should be returned to the owner free of tax.[1] This very liberal income-tax law made it much less necessary in America than it was in Britain to make extensive special concessions for depreciation and amortization in the excess profits tax. The special amortization allowance given in the United States was confined to 'buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German government'; it gave a 'reasonable deduction for amortization of such part of the cost' as had been borne by the taxpayer.[2] These special amortization allowances could be reckoned for purposes of income tax up to the year 1924.

The definition of invested capital. For a high profits tax, like the American, the definition of invested capital is obviously a matter of the first importance, since it determines the standard above which profits become taxable. The Americans began with a very crude capital concept, but they improved it considerably in their successive enactments. The definitions which were actually enforced

[1] In the early years of the American income tax (after 1913) the fixing of suitable rates for capital depletion was left to administrative discretion; later legislation has tended to prescribe directly the rates appropriate to particular industries. Thus an annual allowance of 27½ per cent. of the gross income was prescribed for oil and gas wells in 1926. (Cf. Spaulding, *The Income Tax in Great Britain and in the United States*, London, 1927, ch. xiii.)

[2] This allowance only operated from 1 January 1918. The amount of the special amortization allowance was limited to the difference between the cost of the asset (less depreciation up to 1 Jan. 1918) and its value on a post-war basis. This was an eminently reasonable provision. For the question of special amortization as it arose in the legislation of 1940, see below, p. 134.

were reasonably sensible; their practical working did not differ very much from that of the percentage standard in England. Nevertheless, the route by which these definitions were reached is rather instructive.

The abortive provisions in the Act of Special Preparedness (March 1917) defined the capital of a business as the sum originally paid in (that is, usually, the nominal share capital) *plus* any reserves which may have been accumulated out of undistributed profits. It is not surprising that this should have been the sort of definition of capital which was originally in the minds of those responsible for introducing the high profits principle; but it is quite clear that the working of such a definition must produce quite intolerable injustice. There are in fact three ways in which the share capital of a company is built up: first by actual subscriptions of cash; second by the sale of property (material or immaterial) to the company, shares being given in exchange; third by the issue of bonus shares. The most important case of the second method is the vendors' share, taken by the original proprietors when a private firm is converted into a company, and by the company promoter when a new company is formed to exploit a patent; the whole point of floating the company is to secure a larger cash value to the vendors than they could secure by selling their property outright. Thus the second method is almost bound to involve some watering of capital (the term need not be used in any derogatory sense); the third method is pure watering.

The first American definition (if it had become effective) must therefore have favoured the company with watered capital against the company which had not watered its capital in one of these ways. It would have favoured the concern which had undergone financial manipulation against the one which had not. Broadly speaking, this must have meant that it would have favoured big business—which can hardly have been the intention in the minds of its authors when they drew it up.

Later legislation met these difficulties in the following way. Invested capital was to include (1) actual cash bona fide paid in for stock or shares; (2) the actual cash value of all property other than cash, bona fide paid in for stock or shares, reckoned at the time of such payment,[1] provided that this was in no case to exceed the

[1] This is the wording of the Revenue Act, 1918. In the Revenue Act, 1917, the value was to be reckoned as at 1 January 1914, subject to the same condition.

par value of the original stock or shares, specially issued therefor;[1] (3) undistributed profits accumulated as reserves prior to the taxable year. In this way watered capital was largely excluded, though it must be supposed that the calculations involved in the computation of capital according to this formula had a wide margin of error.[2]

The chief practical difference between the British definition of capital and the revised American formula was that the Americans always treated the sum originally invested as an irreducible minimum, even if part of it had been lost in the meantime. The British percentage standard was partly used as a means of exempting the firm which had been doing badly in the pre-war period, and was now doing rather better; the American formula was distinctly kinder to such firms than the British. In spite of that, the sum originally invested—originally invested at any sort of date—was not a very sensible criterion for exemption.[3] The American definition of capital scattered its favours rather blindly.

One further point requires to be considered under this heading—the question of investments. The general principle was that investments were included in capital, just as the income from investments was included in income, excepting when the investments were in concerns which were already liable to income tax. This parallelism was perfectly reasonable, but there was one point where it broke down. A large proportion of government securities were tax-exempt, so that the income from them did not have to be included in taxable profits; the securities themselves could, however, be reckoned as capital. There is nothing to be said about this absurd arrangement except that it was an inequitable, expensive, and surely quite unnecessary way of supporting the bond market.[4]

But this interesting approach to the British method of valuing capital on the assets side would not square with the rest of the construction, so it was subsequently abandoned.

[1] There was a further provision that the value to be attributed to 'intangible property' was not to exceed a certain percentage of the nominal capital. In the 1917 Act intangible property chiefly meant goodwill, and the percentage was 20 per cent.; in the 1918 Act patents and copyrights were included, the limit being raised to 25 per cent.

[2] In view of the extremely recent origin of the income-tax administration, past events must have been singularly difficult to check.

[3] See above, p. 40.

[4] As we have seen above (p. 53), there is quite a good case for including investments in government securities in capital, where the income from such investments is included in taxable profits. That is not what the Americans did.

Administration. It will be evident from the account which we have given that the American excess profits tax must have imposed an enormous amount of work upon the Bureau of Internal Revenue, and at the same time have concentrated an enormous amount of power in its hands. The amount of work involved is illustrated by the fact that the number of people employed by the Bureau rose from 277 in 1913 to 6,996 in 1921 (though of course the excess profits tax was only partly responsible for this). The concentration of power was enhanced by the lack of any appeal tribunal (such as the British Board of Referees) outside the administrative service, and also by the very odd provision which was made to deal with hard cases.

We have already had occasion to refer to the 'representative concern'. In cases of hardship, or when the Bureau was unable to determine the invested capital, it was empowered to fix the amount of tax to be paid by comparison with a 'representative concern' in the same line of business. The tax due was to be the same proportion of net income as in the representative concern (the minimum allowance of $3,000 being excluded from the net income in each case). The hardship, on account of which this method of assessment might be used, was defined as gross disproportion between the tax payable on the ordinary basis and that payable by reference to the representative concern. Thus the representative concern became a sort of alternative standard, though it was left very much to the discretion of the authorities when it was to be invoked. Unfortunately, we have no information how this discretion worked. It would appear that it must always have been to the advantage of a company with better-than-average luck or better-than-average management to get itself transferred to the 'representative concern' basis, if it could find any reason with which to persuade the authorities that it was being hardly treated; for the only instruction given about the choice of a representative concern was that it must be 'as similar as possible' to the company in question 'with respect to gross income, net income, profits per unit of business transacted and capital employed, amount and rate of war profits or excess profits and other relevant facts and circumstances'—and that its invested capital should be capable of being satisfactorily determined. Obviously this is no unambiguous definition; it could have been employed in a way which would have greatly favoured the more successful firms if the authorities had so

desired. The only legal check—a very necessary one—was that if 50 per cent. or more of the gross income of a company had been earned by government contracts on a 'cost plus' basis during the eighteen months of hostilities, the representative concern could not be invoked.[1]

There is altogether not much to be said for this really rather childish arrangement. Cases must continually have arisen when there was no representative concern which resembled the actual concern at all closely; when this happened, either no relief could be given, or it had to be given on a basis which was only remotely relevant to the case in point. Since the whole procedure took place by administrative discretion, the taxpayer must frequently have been presented with a bill whose precise amount was utterly unintelligible to him. It is not surprising that a few years of this system should have built up a volume of resentment which forced the repeal of the tax.

These defects were defects of legislation, not administration. Indeed, when one allows for the recent origin of the federal income tax, for the consequent inexperience of the staff, and for its rapid turnover,[2] the efficiency of the tax collection was very creditable. The violence of its impact on industry was somewhat reduced by the importation of a number of business experts and economists as 'Advisers and Reviewers' to work out the first instructions and interpretations. In one way or another, the revenue was brought in; the official figures are given in the table overleaf.

It will be seen that although the yield from the excess profits taxes is classified according to the year of assessment, it is possible to get some idea of the lag in collection by comparing the two figures for income and profits taxes taken together. Arrears were quite moderate; but the peak of receipts from the war taxes was in 1920.

As for the economic effects of the tax, the main things which have to be remembered are that there was only one year when the weight of the tax was at all severe; that this heavy tax was imposed

[1] The representative concern was first introduced in the Revenue Act 1917; but its application was then mainly confined to companies whose invested capital could not be calculated. Its wider possibilities were developed in the 1918 Act, which also (as we have seen) applied it to the case of new companies.

[2] Cases of gamekeeper turning poacher—revenue officials taking jobs in private business—were, of course, not unknown in America.

retrospectively, so that it was never likely to have had much repressive effect on business enterprise; and that the same law which imposed the high rates of the war profits tax also imposed a much more moderate tax to come into force from that time on. Over the whole period of the excess profits tax, the burden of profits taxation was extremely moderate. During the years 1916–20 inclusive the total profits of American business are said to have amounted to $47,000 millions, of which no more than $9,000 millions were taken in taxation.[1] Business reserves were not depleted;[2] in money terms they rose a great deal, very likely enough to compensate for the rise in prices. In the golden years which were to follow there was not much sign of capital shortage.

On the question (which, as we have seen, was much debated) whether the excess profits legislation discriminated against the small firm, some interesting but inconclusive figures were given by the Treasury as respects the year 1918. It would appear from these figures that the concerns with a very high rate of profit on invested capital (over 30 per cent.), which therefore paid more than

American War Taxation

(Millions of dollars)

Taxable (calendar) year	*Amounts due* from E.P.T. and W.P.T.*	*Amounts due* from all income and profit taxes*	*Fiscal year*	*Receipts† from all income and profit taxes*	*Total† Federal Revenue*
1916	—	345	1917	360	1,124
1917	1,639	2,938	1918	2,314	3,665
1918	2,506	4,286	1919	3,019	5,152
1919	1,432	3,445	1920	3,945	6,695
1920	989	2,700	1921	3,206	5,625
1921	335	1,421	1922	2,068	4,109

* U.S. Treasury, *Statistics of Income*, 1922, quoted R. G. and G. C. Blakey, *The Federal Income Tax*, p. 195

† *Report of Secretary to the Treasury*, 1938, p. 413, table 7.

50 per cent. of their net incomes in income tax and excess profits tax, were mostly firms of less than the average size.[3] But the number of firms which fell into this category was only 20 per cent. of the total, so that it is impossible to deduce that the small firms

[1] Minority report of House Committee on Act of 1921, quoted in Blakey, *The Revenue Act of 1921*, pp. 91–2.

[2] Cf. J. M. Clark, *The Costs of the World War to the American People* (Carnegie Series), p. 136.

[3] The full figures are given in Blakey, op. cit.

were as a general rule more heavily taxed. The statement[1] that in this same year 1918 more than half of the receipts from the excess profits tax were raised from no more than 1,026 companies seems to point in the other direction. But whether the discrimination implied in the tax tended in favour of large firms or small firms, unjustifiable discrimination undoubtedly did exist on a large scale. The Americans succeeded in imposing an excess profits tax which yielded a large revenue, and which did no serious damage to industry; but they did not succeed in imposing one which was even superficially fair.

Later American Legislation

Between the tax repealed in 1921, and the new tax imposed in 1940, there stands in American fiscal history one curious experiment in excess profits taxation. This was the excess profits tax of 1934, still in force, but now known as the 'declared value excess profits tax'. It works in the following way. Companies are made to declare their 'capital', and on this 'capital' they pay the 'capital stock tax'—a minute tax of $\frac{1}{10}$ per cent. But since they can declare any figure they choose, they have to be prevented from declaring too low a 'capital', and this is done by providing that any profits in *excess* of 10 per cent. (formerly 12 per cent.) on the declared capital are taxed at the rate of 10–12 per cent. (formerly 5 per cent.). It is obvious that the practical effect of this arrangement must usually be that the declared value is simply ten times the current profits—for this is the figure which will minimize the tax burden. There is no incentive to take the trouble which would be involved in a more complicated calculation.

How the tax works will depend upon the frequency with which new declarations are allowed. If new declarations were allowed every year, the excess profits part of the apparatus would never yield anything appreciable, and the capital tax would become a straightforward tax on profits at a rate of 1 per cent. If new declarations were not allowed, the excess profits tax would in fact become a tax of the 'war profits' variety; it falls on profits in excess of 10 per cent. of the declared capital—and that would mean on profits in excess of those of the year of first declaration. In fact, new declarations have been allowed fairly frequently, but not so frequently as to prevent the D.V.E.P.T. from yielding some revenue. The revenue from it has always been very insignificant; its companion, the capital stock tax, has always brought in more, in spite of its very low rates.[2]

The 1940 revolution in American foreign policy is reflected in the excess profits legislation of the year. In the first phase, anti-war sentiment was expressed in the Vinson-Trammell Act (March 1940); this limited profits

[1] In the same minority report (quoted in Blakey).

[2] The highest yield of the capital stock tax was $140 millions; of the D.V.E.P.T. $37 millions. Both of these were in 1938, when the total internal revenue of the federal government was $5,600 millions.

in the warship and aircraft manufacturing industries. In effect it was a 100 per cent. excess profits tax on the war industries, without any provision for special amortization of war equipment; thus it prevented any expansion of plant in these industries, excepting when the expansion was financed directly by the American (or British) government. In October it was swept away, and replaced by a new general tax on excess profits of corporations.[1] The new tax was at moderate rates (25 per cent., rising to 50 per cent. on the fraction of excess profits which exceeds half a million dollars); generous provisions are made for special amortization of war equipment (20 per cent. of the cost of any war equipment installed after June 1940 can be deducted from taxable income in each year for five years). While the Vinson Act was clearly intended to restrict war industry, the new Act is clearly intended to encourage it.

The new excess profits tax is formally a hybrid, since there is a war profits basis (95 per cent. of the average profits earned during 1936–9) as well as a high profits basis (8 per cent. on invested capital).[2] The two are alternatives[3] but the 8 per cent. percentage standard looks like being the more effective on the whole. The definition of invested capital seems to be substantially similar to that arrived at in the last war; not much progress has been made here, so that it must be expected that there will be trouble in this direction. There is an interesting movement away from American tradition with respect to the definition of taxable profits; 'long-term capital gains' are now excluded. Over the inclusion of borrowed money there is an odd compromise; 50 per cent. of borrowed money is included. The Representative Concern is fortunately dropped; hard cases are to go to the ordinary Board of Tax Appeals (one wonders how this will work). The tax is purely a tax on companies; the 'personal service corporation' (see above p. 123 n.) is excluded.

So far as its general weight is concerned, the new tax was intended for and was perhaps not ill-suited to a condition of non-belligerency, when it is more important to stimulate industrial expansion than to enforce economy. The rates of the excess profits tax were raised by 10 per cent. in the Revenue Act of September 1941. The most important changes in that Act were, however, in the normal income and corporation taxes. The latter, already raised to 24 per cent. on company profits exceeding $25,000, was further reinforced by a surtax (6 per cent. on profits below $25,000, 7 per cent above that figure). Up to the end of 1941 the excess profits tax remained a relatively minor source of revenue; whether it will remain so during the period of actual belligerency is another matter.

[1] Second Revenue Act of 1940.

[2] In 1941 this became 7 per cent for companies with over $5 millions invested capital.

[3] The taxpayer pays on whichever basis makes the tax lower (as in the British E.P.D.) not higher (as in the American Tax of 1918).

CHAPTER XIV

GERMAN FINANCE IN THE WAR OF 1914

QUITE apart from its intrinsic importance, the story of German finance during the last war is of very particular interest for our purposes. It is the only case known to us of a belligerent country which has tried to rely upon capital levies and excess profits taxes—the sorts of tax which are our particular subject—as its major sources of tax revenue in war-time. This was an extraordinary thing to do, and it had the results—the disastrous results—which might be expected. War-wealth taxes are expensive taxes to collect, and so (of course) they were very imperfectly collected; even if they had been better collected they could only have become large sources of revenue when buoyed up by inflation—and that made the collection all the harder. The German Government shifted from one war-wealth tax to another, but one was no better than another; without a firm substructure of ordinary taxation to bear the main financial weight of the war, all these taxes proved in the end perfectly futile.

The primary reason for this strange state of affairs was the division of revenues between national and regional governments—a trouble which has affected other countries, but none to such a disastrous extent as Germany. The Federal Government of the United States had succeeded in getting power to impose an income tax just before 1914; the Federal Government of Germany did not secure that power until the time of the Weimar Constitution. The Government of Wilhelm II did not even possess any fiscal administration at all comparable with the British Inland Revenue.

A government like this, engaged in war, had no choice but to finance the main part of its war expenditure out of borrowing. The monetary theories of Knapp and his followers may have had something to do with it (with their neglect of the economic factors affecting the value of money); but for the most part the loan policy was forced upon the Reich by its internal structure. Similarly, although the partiality for capital taxes—if there were to be war taxes—was to some extent a matter of academic tradition (Wagner and Diehl are representatives of an economic opinion which specifically favoured the use of capital taxes in emergencies) the

resort to such taxes was mainly a result of the fact that the normal direct taxes were a monopoly of the States. The Reich had to confine itself to emergency taxes in order to keep within its constitutional limitations.

The first of the special war levies was imposed some time before the beginning of the war. Military expenditure was mounting up, and in 1913 it was decided to meet it by means of a comprehensive levy on individual and corporate property—the *Defence Levy* (*Wehrbeitrag*). The rates of this levy were very low (ranging from 0·15 per cent. on the first 50,000 M. to a maximum of 1·5 per cent.), so that it was only upon the largest estates that the burden was at all appreciable; this reflected the success of the Socialists at the 1913 elections. More than 50 per cent. of the revenue was collected from taxpayers whose property was over a million marks.[1] Small companies, and small properties on which the return was low, were exempted.[2] But (an interesting indication of the way the levy was designed to circumvent the States' monopoly of income taxes) high incomes were included in the levy, even when there was no corresponding capital. The assessment was based on the assessment for the State income taxes; incomes under 5,000 M. were exempt; the progression ranged from 1 per cent. on incomes up to 10,000 M. to 8 per cent. on incomes over 500,000 M.

This levy was later to be used as a basis for other levies; some of its provisions were to be of considerable importance later on. Clothes and household goods of all sorts were excluded, including luxury goods and *objets d'art*. When prices began to rise, this gave a direct incentive to the acquisition of such goods. Valuation was carried out carefully, so far as the administrative machinery allowed; so far as possible it was on a selling-price basis. It is an interesting point that Germany was the only one of the belligerents which had equipped herself in advance with a census of the distribution of property before the war.

In addition to the defence levy, another emergency tax was imposed in 1913—the *Besitzsteuer*, a tax on the increment of wealth over a three-year period. It was also imposed at low rates, only rising to $2\frac{1}{4}$ per cent. on the enormous *increment* of 10 million marks.

[1] Cf. the official publication *Bestimmungen über die Wehrbeitragstatistik* (Statistisches Reichsamt, Berlin, 1920).

[2] There was an absolute exemption of property up to 10,000 M. Property up to 30,000 M. was exempted if the income from it did not exceed 4,000 M., and up to 50,000 M. if the income did not exceed 2,000 M.

The defence levy had to be paid in three instalments—one in the autumn of 1913, one in February 1915, and one in February 1916. *During the whole of that time there was no further increase in taxation.*

Apart from this pre-war levy, the history of German war taxation does not begin until June 1916, nearly two years after the outbreak of war. Prior to that time there was only one measure which had even some of the effects of a tax—the profit-blocking law of December 1915, which we shall describe below. War expenditure, already on a very large scale, was financed almost entirely out of loans; even when the natural consequences of this reckless loan finance began to be apparent, little notice was taken of them. There was an enormous number of new company issues, many of which were, in accordance with German practice, financed by the banks. There was an outburst of speculation on the stock exchange, but nothing was done about it. It must, of course, be remembered that in 1914 Germany had large reserves of gold and foreign assets. In the first two years of the war she realized a considerable proportion of these reserves, which somewhat mitigated the effects of her internal policy. But it cannot be doubted that the seeds of future inflation were sown, and already germinating, in these two years of financial *laisser-faire*.

A short war, to be paid for afterwards out of the indemnity exacted from a defeated enemy—that had been the Bismarckian ideal; to abandon it in favour of taxing one's own people seemed already a confession of failure. Yet in the middle of 1916 war taxation was no longer avoidable; more taxes were needed if the mere interest on the already incurred debt was to be met out of revenue. So we come to the tax law of June 1916. Indirect taxes and State monopoly prices were increased; a new stamp duty on business turnover was introduced.[1] Then, since profiteering was already becoming an issue (naturally enough in view of the gathering inflation, quite apart from other causes), two special taxes were imposed to deal with war wealth. These were an excess profits tax on companies, and a new levy on the increment of personal wealth.

The excess profits tax had already been foreshadowed in the

[1] This was the forerunner of the general turnover tax, a bad but prolific tax, which was to be a great standby in post-war finance, in Germany as in other countries. There was also a tax on the profits of the Reichsbank; cf. W. Lotz, *Die deutsche Staatsfinanzwirtschaft im Kriege* (Carnegie Series, 1927).

blocking of the previous December, to which we must now return. Companies had been required to invest in government loans 50 per cent. of the excess of their current profits over the average of the five pre-war years. The purpose of this blocking seems to have been to secure that the funds which would subsequently be needed for payment of the excess profits tax would be available in liquid form. The blocking was kept in force until the end of the war, but as the rates of excess profits tax rose, the proportion of excess profits which was blocked rose with them. It was a kind of preliminary lien on the excess profits; a large proportion of the excess was first blocked, and then, later on, when the proper calculations had been made, a proportion (in principle smaller) was definitively taken in tax. As we have seen in earlier chapters,[1] a device of this kind, if properly worked, might be a very useful engine of financial control. But it would require very careful administration to prevent evasion; the general history of Germany's fiscal machinery does not suggest that it is likely to have had very careful administration at that time.

The German excess profits tax adhered formally to the war profits principle. The tax was levied (like the blocking) on the excess over the average profits of 1910–14, a minimum excess of 5,000 M. being tax free. But there was also an alternative minimum standard of 6 per cent. on capital invested—capital invested being defined in the same crude way as it was in the first American legislation (paid-up capital plus open reserves, as entered in the published balance-sheet). It was no doubt inevitable that a simple definition of capital should be adopted in the first place, owing to the absence of income-tax records; but there is no evidence of any attempt to substitute a more equitable concept as experience was gained (as the Americans did).[2]

The rates of the tax were incredibly complicated. There was a double progression, partly depending upon the ratio of the excess profits to capital invested, partly on the ratio of total profits to capital invested. This meant two separate scales which had to be added together. The first scale ranged from 10 per cent. where the *excess* profit was less than 2 per cent. of the invested capital,

[1] See above, esp. chs. vii and xii.

[2] The Germans seem to have retained this insensitiveness to the finer shades in the definition of business capital; which is one of the reasons why the German capitalist can still sometimes get away with it, even in the Third Reich! See below, p. 145.

to 30 per cent. where the *excess* profit was more than 15 per cent. of the invested capital. The second scale ranged from 10 per cent. where the *total* profit was less than 8 per cent. of the capital invested to 50 per cent. where *total* profits exceeded 25 per cent. of invested capital. Both of these scales were applied to the *excess* profits. Their combined effect was to impose a tax which usually ranged from 10 to 45 per cent. of excess profits.

The new levy on the increment of personal wealth, also imposed in June 1916, was based on the valuations made for the pre-war defence levy;[1] it taxed increments of wealth which had accrued between the end of 1913 and the end of 1916. The rates varied from 5 per cent. on the first 10,000 M. of increment, and rose in fractions to 50 per cent. on as much of the increment as exceeded one million marks.[2] There was a double exemption, of property below 10,000 M. and increment below 3,000 M.

The taxes imposed in 1917 do not concern us;[3] but those in 1918 were more important. The stamp duty was transformed into a fully developed turnover tax; there was the usual increase in indirect taxes. There was a rise in the rates of the excess profits tax, with the result that the progression now ranged from 30 to 60 per cent. To mitigate the effect of this a system of suspense accounting was introduced (more or less on the British model), whereby a deficiency was set off against subsequent liability; there was, however, no provision for actual repayment.

The most important innovation of 1918 concerned the increment levy. It is clear that this had been a complete failure. It was therefore decided to replace it by an excess income tax, accompanied by a small tax on total property as computed at the end of 1916. The excess income was reckoned as the excess above the last pre-war assessment in the States. The excess income tax was first levied for the calendar year 1918, at rates ranging from 5 per cent. on the first 10,000 M. of excess[4] to 50 per cent. on the fraction

[1] Its scope was, however, somewhat more comprehensive, jewellery, art collections, gold and silver, &c., were included.

[2] A peculiar clause of the law provided that where there was no increment, but a decrement of less than 10 per cent., a levy of 1 per cent. was imposed on as much of the value of the property as exceeded 90 per cent. of the pre-war value.

[3] Excepting that there was a supplement of 20 per cent. on the increment levy, and a supplement to the tax on the profits of the Reichsbank. The rest were indirect taxes of various sorts.

[4] Incomes of less than 10,000 M. and excess incomes less than 3,000 M. were exempt.

of excess over 200,000 M. The property tax was levied at the insignificant rate of 1 per mille on the first 200,000 M., rising to 5 per mille on the fraction over 2 million marks.[1]

The change from war to peace, and from Empire to Republic, did not itself mark the end of this frenzied finance. In the year 1919 the rates of the excess profits tax were raised for the third time—to a range of from 40 to 60 per cent. There was a rise in the excess income tax, but it only applied to the highest fraction.[2] The property tax was abolished. Of course the new régime had to mark a new era with new and much-advertised taxes of its own; before 1919 was out high-sounding innovations had been introduced. So-called innovations; for in fact they were nothing else but new doses of the same medicine. A new personal increment levy was imposed in September; surely the Weimar cat would catch that mouse when the Hohenzollern had failed! On 31 December the Reichstag passed into law a grand new levy on total wealth—the National Distress Contribution (*Reichsnotopfer*); the cat was still up to the old tricks! We shall see in a later chapter what came of it.[3]

Much more significant, especially from the long-run point of view, was the fact that by the end of 1919 the beginnings of a competent fiscal administration for the Reich were already in being. With the new constitution the Reich acquired full fiscal supremacy, and the right to impose direct taxation without restriction. Notwithstanding all the disturbances of the inflation years, the foundations of a reasonably sound tax structure began to be laid.

The revenue produced by the war taxation of Imperial Germany was fantastically small, even in money terms.[4] Total war expenditure during the four and a half years amounted to 147 milliard marks. Almost the whole of this was met by borrowing or by monetary expansion. Total tax revenue amounted to about 20 milliards, hardly more than sufficient to cover the 17 milliards of 'ordinary' expenditure.[5] More than two-thirds of the revenue

[1] Property of 100,000 M. and under was exempt.

[2] The tax on the fraction over 400,000 M. was raised to 70 per cent.

[3] See below, ch. xxiv.

[4] R. Kuczynski, 'German taxation in the World War' (*J.P.E.*, Chicago, 1923); Charles Rist, *Les Finances de guerre de l'Allemagne* (Paris 1921); the work of K. Bräuer, *Die Besteuerung der Kriegsgewinne in den europäischen Staaten*, 1921, is not very illuminating.

[5] Helfferich, *Money*, vol. i, pp. 224 ff.

from the special war taxes was collected after the war when the value of the mark was rapidly depreciating.

The absence of a competent tax administration was, of course, the chief reason for this absurd result. But, given this administrative situation, the position was made ten times worse by the choice of these special emergency taxes, which impose the maximum strain upon the collectors of revenue. The perpetual computations of capital and such tiresome complications as the double progression of the excess profits tax, all these things wasted time—invaluable time. The only idea of war taxation which the Germans had inherited from their traditions was that of special capital taxes, to be imposed once for all. When, at the end of 1919, the capital levy turned up for the last time, it was greeted by the Press with a phrase which sums up the whole story—'Wieder das Einmalige'.

CHAPTER XV

NAZI WAR FINANCE

THE change in the fiscal system of Germany between 1914 and 1934 is one of the most striking administrative revolutions of history. In place of a national government devoid of a competent revenue department and having to bow to the prior exploitation by the States of the most prolific taxes, the Nazis possess a highly centralized and competent administration, able to impose not merely any tax it likes, but also any subsidiary method of control. It is true that the States continue to derive some of their revenue from direct taxes, but only under the licence and direction of the Reich. In the field of local finance the grant-in-aid has even appeared in place of the independent exploitation of taxable capacity.[1] This revolution is by no means all the work of the Nazis. The foundations of the new system were well and surely laid under the Weimar Republic. This is not entirely obvious because the process of readjustment of the relation between central and local revenues naturally took time. The seal was set on the reform by a thorough codification of the fiscal system in 1934, one of the first acts of the Nazi government.

When the Nazis came into power they were able to take over not merely a competent and already experienced administration but also a fully developed tax structure. This was devised with care and equity, but it was distinctly onerous. Taxes had been raised to an unprecedented height by the Bruning government during the depression, in a vain attempt at closing the gap in the budget caused—indirectly—by the sudden cessation of foreign lending. Thus in the early years of their dominance the Nazis had for the most part nothing to do but sit back and watch the revenue steadily mounting as the country climbed out of depression by natural and artificial means, while at the same time they were able to secure an ever larger proportion of the growing national income to finance their adventures.

The basis of this weighty but efficient tax structure was the income tax, which was responsible for nearly half the total tax revenue of the Reich.[2] Not only the tax on income from securities,

[1] Cf. Newcomer, *Central and Local Finance in Germany and England*.

[2] Including the corporations tax with income tax.

but also that on salaries and wages was deducted at the source, thus facilitating the control of consumption and providing for the continuous collection of revenue.[1] In 1939 the rates on personal incomes varied from 1·66 to 50 per cent. The rate on corporate profits was 30 per cent.[2] In the indirect field the dominant source of revenue was the turnover tax. Before 1939 it was responsible for about one-fifth of total tax revenue. It was levied at 2 per cent. on every stage of manufacture and merchanting. In other respects the tax structure was normal, save for one item. This was the tax on flight from the country, which implied the confiscation of a very large proportion of the property of émigrés. Fiscally it must be described as a wasting asset.

Special war measures may be said to have started in 1934. Besides the general codification already mentioned, the rate of the tax on profits was raised, and a dividend-blocking law was introduced. Originally this prescribed that dividends might not exceed the amount distributed in the year 1932–3, or 6 per cent. on the capital, whichever was the higher. Profits in excess of this amount were to be retained by the company, but were to be invested in government securities. The object of the measure was stated to be strengthening of the market for government bonds. From this time also began to appear the numerous forms of unofficial taxation and compulsory saving, such as Winter Help, Labour Front, Strength Through Joy, People's Car, &c., whereby additional earnings have largely been returned to the State as they accrued. It is considered by some neutral sources[3] that on the average 25 per cent. of the personal incomes of the working classes was secured for the State by these means. A further step was taken towards the complete control of incomes by the introduction of a new system of price control in 1936.[4]

The next important fiscal move was taken in 1937, and thus synchronized with the first British move, the imposition of the

[1] Under the German system the deduction at the source of income from securities appears to be considerably less thorough than under the British system.

[2] Cf. *Frankfurter Zeitung*, Wirtschaftskalender, 1940.

[3] For instance, K. Poole, *German Finance, 1932-39* (Cambridge, Mass., 1939), p. 173. The official figure is considerably lower. (Cf. J C. de Wilde, *Germany's Controlled Economy*, Foreign Policy Reports, New York, March, 1939.)

[4] This side of Nazi policy lies outside our field. It can be studied at length in Guillebaud· *The Economic Recovery of Germany*, Poole, op. cit., Balogh: especially: 'The National Economy of Germany', *E.J.*, Sept. 1938, and Bank for International Settlements, *10th Annual Report*, May, 1940.

National Defence Contribution. In September 1937 a 'non-combatants'' tax[1] was imposed for the first time in Germany. It took the form of a surcharge on the income tax, payable by males born after 1913, not serving with the forces. The rates were fixed at 50 per cent. of the income-tax assessment for the first two years, and thereafter 6 per cent.[2] The aim of this peculiar arrangement would seem to have been to provide a further means of effecting an immediate reduction in the spendable income of labour, but its form throws a curious light upon official anticipations of the duration of the emergency then being prepared for.

The same year saw the revision of the dividend blocking measure. The first plan of allowing funds to be kept and invested by the firms was almost immediately found to be unworkable. Even before the end of 1934 it had been decreed that profits in excess of the amount authorized for distribution[3] must be paid over to the Golddiskontobank, there to be invested in government bonds. Shareholders retained their rights over the funds, but they were not to be released for three years. In 1937 it was announced that the blocking would be renewed for another three years. The argument this time was that the arrangement enabled firms to build up their reserves. At the same time it was intimated that the deferred profits would be repaid only in (doubtfully negotiable) tax certificates.

The profit blocking which accompanied the excess profits tax in the 1914–19 period was deemed to have been a successful operation, and seems to have given satisfaction to the revenue authorities. This was partly, no doubt, because their standards were not very high, and they regarded it mainly as a means of assuring more ready payment of excess profits duty.[4] The corresponding[5] legislation of 1934–9 seems to have given no satisfaction at all. At the end of 1937 the total fund amounted only to Rm. 102·5 millions. This has since been repaid in tax certificates, redeemable

[1] *Wehrsteuer*, cf. the French and Italian measures described, pp 151, 153, 158.

[2] With a minimum of 4 per cent. of income, where tax was deducted at the source (5 per mille after two years); and 5 per cent of income where a separate assessment was made (6 per mille after two years).

[3] 6 per cent. in most cases.

[4] See above, p. 138.

[5] In spite of obvious similarity there was a fundamental difference between the two measures. In 1914–19 only a portion of the excess profits were blocked, so that there was only indirect dividend limitation.

in five years' time. The released profits (or such as remained after a 20 per cent. depreciation of the certificates) were distributed among the shareholders; the companies themselves retained the certificates to pay their taxes. Even with the close controls of Nazi Germany, from the first only a small number of companies failed to find a means of avoiding the obligation. In 1937 only 369 companies had to make a contribution to the fund. In 1938 their number had shrunk to 339.[1] It may be surmised that one of the chief reasons for the failure of the blocking device was the absence of an excess profits tax (which was not imposed until 1939). Other methods of control, however drastic they may appear, cannot be substituted for a thorough examination of company accounts by the revenue authorities.[2]

The early months of 1939 saw the introduction of an elaborate New Finance Plan. Among other things it provided for the financing of a portion (up to 40 per cent.) of government contracts by so-called tax certificates which were of limited negotiability, but which on maturity might be used by the holders to discharge their tax liability. We need not go into the details of this and other non-fiscal parts of the plan. The tax certificates only concern us because a new excess profits-cum-excess income tax was introduced with the ostensible purpose of covering the gap which would arise in the revenue when the certificates began to flow back to the Treasury. The tax certificate plan did not give satisfaction, and after the outbreak of war the government returned to 'straight' borrowing, mainly by means of Treasury bills and short-term loans. The excess profits tax lasted another year.

The scope of this tax was identical with that of the corporations profits tax and the personal income tax, except that the profits of agriculture and forestry were exempt. In the personal sector there was an exemption limit of Rm. 6,000, and the first Rm. 1,200 of excess was tax free. Legacies, expenditure on business expansion, and additional income due to normal promotion, were disregarded in the year in which they occurred. The strange feature of the tax was, however, that excess was measured from year to year, not from a pre-war standard, as has been the practice

[1] Cf. *Der deutsche Volkswirt*, 6 Apr 1939, and *Die Wirtschaftskurve*, 1938, p. 294.

[2] The examination of books which is required for a permanent tax such as the corporations profits tax is, of course, much less thorough than is necessary for an excess profits tax; see above, p. 76.

with every other 'war profits' tax. The rate imposed in 1939 was the moderate one of 15 per cent. This became 30 per cent. in 1940, and a further rise was foreshadowed; but instead the tax was abandoned in the autumn of that year. A long list of concessions for hard cases had already whittled down the revenue from both sections to a point where it can hardly have been worth collecting. The low rates and peculiar method of measuring excess must alike have prevented the tax from exerting any useful economic effect.

These were the war taxes which had been put into operation in Germany before the outbreak of hostilities. But more was to come. The War Economic Decree of 4 September 1939 contained a number of fiscal measures. Besides the usual excise increases there were two measures in the same field as the excess profits taxation—a doubling of the established tax on directors' fees (which thus became 20 per cent.), and a direction to firms to block payments for overtime and Sunday work, and to invest them in government bonds. At the same time the States and other local authorities were directed to increase their contributions to the Reich. The most important change, however, was a 50 per cent. surcharge on the general income tax.[1] Of all the new measures this was clearly the most effective, since even before the rate was raised income tax provided about one-third of total revenue. The corporations profits tax, which was levied at 40 per cent. in 1940 was also a useful source of revenue. On the other hand, considerable gaps must inevitably have been caused in the revenue from normal indirect taxes by the extensive system of rationing.[2]

The further history of Nazi war finance is confused and obscure. The most outstanding point has been the preference for direct administrative control of prices and profits rather than fiscal measures. In such a régime an endless series of decrees limited to particular categories on the one hand, and on the other innumerable provisions for hard cases, come more and more to take the place of open and general legislation. It may be surmised that the taxpayer is nearly as much in the dark in trying to pick his

[1] The supplement cannot exceed 15 per cent. of the taxable income, or together with the income tax 65 per cent. of taxable income. (The comparable British figure—income tax *and* surtax—was already over 85 per cent. in 1940.)

[2] Although this was denied by Finance Minister F. Reinhardt, in Völkischer Beobachter, quoted in *Economist*, 26 Oct. 1940.

way through the maze of official pronouncements as is the foreign historian. The treatment of excess profits after the withdrawal of the excess profits tax is an illustration of the increased reliance on direct control. Decrees from the Price Control Office were first issued for particular industrial and commercial categories, and have been successively extended so that by the end of 1941 they covered even professional fees.[1] These orders are ostensibly based on the War Emergency Decree of 1939, which defined allowable profits as only those 'proper to a nation at war'. The procedure appears to be that the firm or individual has to present to the Price Control Office particulars of trading results, tax liability, and cost and price structure. Any excess profits revealed by these calculations are paid into the tax office, but the main purpose of the procedure appears to be to enable the Price Control Office to enforce a reduction in selling prices, rather than to limit profits or collect revenue.

The second dividend blocking period expired in 1940. After some delay it was announced that the blocked profits would not be released until after the war. At the same time a further period of blocking was foreshadowed. The new scheme, which was eventually introduced in June 1941, substituted a tax on dividends for a profit stop (but as the tax reaches 100 per cent. on a declared dividend of 8 per cent. the difference is not very substantial). The distributable maximum is fixed at 8 per cent., any difference between declared and distributed dividends being compulsorily invested in Treasury Bills. This measure was accompanied by an important concession which permitted firms to write up their capital by the amount of accumulated reserves.[2] The effects of this concession must in many cases have been to neutralize the restriction due to dividend limitation. The revenue will make something out of the arrangement, since new issues are to be taxed—10 per cent. where the capital is doubled, the rate rising

[1] This seems to be equivalent to a partial reintroduction of the excess income tax. In some categories standard income is said to be based on turnover, with bases varying both regionally and industrially—an obvious source of friction; cf *Economic Journal*, Mar. 1942, 'The German War Economy, V'. This method was also used in the French 'Régime of Profit Limitation'; cf. below, p. 154.

[2] In the first instance only reserves accumulated up to 1938 were eligible for incorporation, later the date was extended to 1940 Up to Dec 1941 it is reported that 72 companies had increased their capital (on the average by 30 per cent). *Volkswirt* referred to the phenomenon of 'a capital increase mania', cf. *Economic Journal*, 1942, loc. cit.

to 20 per cent. of the issue where the capital is more than trebled. But the main beneficiaries appear to be the shareholders.[1]

In a totalitarian régime, and especially one administered with German thoroughness, it is impossible to assign the usual significance to such magnitudes as the national income. In the presence of all-embracing controls, and an enormous penumbra of unofficial taxes, figures of nominal revenue, even if correct, cease to have their normal meaning. Only the very broadest lines of the situation can be established. It may be concluded first, that a very much larger proportion of war expenditure is being met out of taxation than in the war of 1914–18. The existence of a strong progressive income tax alone assures that. Secondly, it is clear that even before the outbreak of war the national debt had very considerably expanded. The benefit which the Nazis derived from the dissipation of the old debt by the inflation had already partly been sacrificed.[2] As far as can be ascertained, the proportions of expenditure financed respectively by taxation and by loan do not appear to have differed markedly in 1939–40 from the British proportions, but the concessions of 1941 must lead to a diminution in the proportion covered by taxation.

The fiscal changes reported in the press as having been introduced in the spring of 1942 have not reached us in a form suitable for inclusion in this chapter. But it is clear that they represent a further stage in the process of concession to industrial capital.

[1] Shareholders are not the only beneficiaries under the legislation of 1941. The regrading of the wage tax is said to have led to considerable reduction in the liability of certain income groups. Stamp duties have also been reduced. More important than either of these is that a wide range of income categories, including both workers and business men, may reduce their tax liability by joining the 'Iron Savings' scheme Iron savings are exempt both from income tax and from social insurance contributions. It is estimated that this may cost the revenue Rm. 1,500 millions. The parallel 'blocked investment' scheme in which depreciation allowances can be invested (up to 50 per cent. of their value) extends a similar privilege to firms, cf. *Economic Journal*, 1942, loc. cit.

[2] On the other hand, even the most skilful use of discriminatory exchange control could hardly compensate for the absence of the reserves of gold and foreign exchange which Germany possessed in 1914—and even in 1918.

CHAPTER XVI

FRANCE (1914–18 AND 1939–40)

IT must be admitted that the French fiscal effort during the war of 1914–18 makes a disappointing showing. For the first two years no tax rates were raised, no new taxes were introduced. The tax revenue even in money terms did not reach the pre-war level. War expenditure was financed almost entirely by short-term borrowing, and it was some time before this was funded. It was only in the course of 1916, when the service of the debt was beginning to be onerous, that new taxation was imposed. Even this was designed to do no more than provide for the service of the new debt.

It must be remembered that the whole brunt of the first stage of the war fell upon France, and throughout these two years she was suffering intensely. From the earliest days of the war 20 per cent. of the population was under arms, so that there could be no approximation to normal conditions in any part of the country. The most important industrial regions were in enemy occupation. It was generally expected that the war would not last long, so that it was hoped that drastic increases in taxation might be postponed until hostilities had ceased. There was some apprehension also of the psychological effect of increasing the tax burden during a period of immense national strain.

Besides these explanations of the failure to make a greater fiscal effort there was an important technical obstacle to the adjustment of the French fiscal system to war purposes. France was in the very act of reforming her entire tax structure on the eve of the war. The old system was discredited and over-ripe for abandonment. The machinery of the new had not even been tried out.

The direct tax system of pre-war France dated from the Revolution.[1] It was based on 'Les Quatres Vieilles', proportional taxes assessed separately on real property (*contribution foncière*), on the house occupied (*la personelle-mobilière*), on the number of doors and windows, and on business licences (*patentes*). The assessment was made on apparent value. There were no personal returns. Such levies were obviously quite unsuited to be the basis of the

[1] For a good account of the French fiscal system see L. Trotabas, *Les Finances publiques et les impôts de la France*, 1936.

tax structure of a modern State, and apart from a tax on income from securities imposed after the Franco-Prussian War, expanding needs had been covered by indirect taxes, which had consequently become very heavy. A thoroughgoing reform of the system had long been discussed,[1] but it was not until the first half of 1914 that any considerable reforms were actually introduced. A law of March 1914 reorganized the tax on real property. In July a project for a new and somewhat experimental global income tax was adopted.

It had been intended to bring the new income tax into force at the beginning of 1915, but in the circumstances this seemed too difficult. Its operation was thus postponed for a year. On the other hand, the Chamber would not agree to the doubling of the rates of Les Quatres Vieilles which the Finance Minister proposed as an alternative, since such a course seemed to confirm the very evils which the reform was designed to sweep away. The impasse thus created was, however, surmounted in 1916, and in spite of the immense obstacles to carrying out fundamental changes in the fiscal system during a war, a very considerable part of the reform programme was in fact carried through over the next three years.

The income tax which should have come into force in January 1915 was a proportional tax of 2 per cent. and was still without personal declarations. The Revolutionary ideal of individual independence and secrecy died hard. Taxpayers' returns were, however, introduced into the French fiscal system by an important enactment of December 1916. The rates of this general income tax were raised more than once during the war period, and it was given a mild progression. The next important reform was the introduction of a scheduled income tax on the British plan[2] in January 1918. This was not actually progressive, but allowances in the lower income ranges gave it at least a progressive element. Allowances were graduated according to the number of dependants. At this time Les Quatres Vieilles were finally dispersed, and the remnants handed over to the local authorities.[3] A tax on

[1] It formed part of the Caillaux programme in 1907.

[2] *L'impôt cédulaire sur les revenus.* The schedules were: (*a*) agricultural incomes; (*b*) salaries and official incomes, pensions, life interests; and (*c*) professional and non-commercial incomes.

[3] Except the property tax which had only recently been reformed and was now retained.

profits replaced the *patente*.[1] The tax on income from securities was also extended.[2] During the war period the indirect taxes were also expanded and the rates raised. The most important innovation in this field was a tax on payments which was the forerunner of the general turnover tax which played an outstanding part in the post-war fiscal system.[3] In spite of these efforts, revenue collection remained extremely difficult. Incredible trouble was encountered over the introduction of taxpayers' returns.

So far no mention has been made of any special war taxes. This is because in France they began, and remained, entirely separate from the rest of the fiscal system. This arrangement was similar to that first adopted in Britain for the taxation of munition manufacturers. It may have been fear of the further complication which the addition of temporary taxes would have imposed on the reform programme that determined the French to keep their war taxes under separate management. At any rate the arrangement was no more satisfactory than the more limited experiment of the same kind in Britain. It is hardly to be expected that a job which requires all the abilities of practised revenue officials under war conditions can be successfully performed by amateurs.

Proposals to tax war profits were made in the Chamber at an early stage of the war, but it was not until the introduction of the first big war loan in November 1915 that the government definitely announced its intention of introducing an excess profits tax. The Bill was before the chamber in January 1916 and became law in July. In December 1916 a further special war levy—a non-combatants' tax on all male nationals not serving with the forces—was imposed.[4]

The excess profits tax was levied on profits realized during the period 1 August 1914 to 31 December 1919. It was mainly a war profits tax,[5] based on average profits of the three years ending with the outbreak of war. There was an absolute exemption of 5,000 francs, or alternatively 6 per cent. on the capital invested, or thirty times the *patente* assessment. (The *patente* was still in force at the time of the introduction of the excess profits tax.) The new tax was levied on all payers of the *patente*, on government

[1] *L'Impôt sur les bénéfices industriels et commerciaux.*

[2] *L'Impôt sur le revenu des créances, dépôts et cautionnements.*

[3] Cf. C. S. Shoup, *The Sales Tax in France* (New York, 1930).

[4] This took the form of a small fixed sum, plus a 25 per cent. surcharge on the general income tax.

[5] See above, ch. v.

contractors[1] (including financiers), and on all business and trade subject to the tax on mines. Capital was defined as that actually used and remuneratively employed in the business, but since the *patente* assessment could always be used as a basis, many taxpayers preferred this simpler and less revealing standard, and there was consequently no need to make a capital computation, even for new firms. The legislation allowed for exceptional depreciation on war equipment. Generous interest and depreciation allowances were also given on assets in occupied territory. As first imposed the excess profits tax was a flat-rate levy of 50 per cent. In 1917 an element of progression was introduced. The first 100,000 francs of excess still bore tax at 50 per cent., but above that successive fractions were taxed at progressive rates, reaching 80 per cent. on an excess of 500,000 francs and over.

Prior to 1914 the French budget was of the order of 5,000 million francs, of which about four-fifths was covered by taxes. During the period of war finance (1 Aug. 1914 to 31 Dec. 1919), total ordinary tax revenue was 32 milliard francs—hardly enough to cover ordinary expenditure.[2] During this period only 1·4 milliard francs was collected in respect of the excess profits tax. After the war its annual receipts increased—to 2·9 milliard francs in 1920 and 3·3 milliard francs in 1921. Arrears continued to be collected during practically the whole inter-war period. The total yield is stated to have been about 18 milliard francs. Especially when allowance is made for the rapid depreciation of the franc between liability and collection, it can hardly be called a fiscal success. The historians of French war finance agree in disparaging the fiscal administration during the war.[3]

Perhaps as a result of the strenuous effort to carry through reform during the war, no great advance was made in the French tax system after 1918. Direct tax receipts, and particularly those derived from industrial profits, increased somewhat in relative importance.[4] The turnover tax was responsible for a marked

[1] The exemption limit did not operate for this category.

[2] For a critical account of French war finance see the work of G. Jèze and H. Truchy in the Carnegie series, 1927.

[3] According to Truchy, op. cit., 'it testified to a considerable relaxation of political morality'; and to Jèze, 'A worse fiscal administration it would be difficult to conceive'.

[4] In 1913 the proportion of tax revenue derived from direct taxation was

increase in the yield of taxes on consumption, but this was accompanied by a fall in the receipts from State monopolies. The victory of the new progressive system was assured, and the whole structure was codified in 1934. Nevertheless, fundamental equity between taxpayers was far from being realized, largely owing to the enormous amount of evasion. The gap between assessment and revenue was so wide[1] that the only possible interpretation to be drawn from the figures is that fiscal practice had become completely divorced from the legal intention. Further, the budgetary problem, which had given endless trouble during the inter-war period, had not been solved. A complicated system of separate accounts interfered hopelessly with the unity of the budget and made it impossible to get any conspectus of total expenditure. A large part of rearmament expenditure was charged against such *ad hoc* funds.[2]

On the other hand, France entered the war in 1939 with her fiscal system at least nominally in a less fluid condition than in 1914. This time she was determined to be in good time with war finance. In 1935 a special surcharge was added to the income tax, and this was followed by a 20 per cent. tax on profits from armament contracts. In the spring of 1939 the scope of the armaments tax was extended, and an additional 1 per cent. retail sales tax imposed. Further important measures were taken in the autumn of 1939. These included a supplementary tax on earned income, imposed at 2 per cent. in November but raised to 4 per cent. in January (and to 15 per cent. for non-combatants); a 40 per cent. tax on wages from overtime; and a 'régime' of profit limitation.[3]

Whatever the original intention may have been, this new tax on profits was not an excess profits tax in the sense in which we have previously encountered it. It seems to have been an attempt

23 per cent., and in 1936 it was 31·5 per cent. The distribution of direct tax receipts in 1939 was roughly 30 per cent. from the tax on income from securities, 27 per cent. from the tax on industrial profits, 18 per cent. from the general income tax, and the remainder from land tax and a small amount from the *impôt cédulaire*.

[1] Cf. the figures for 1934, cited by Trotabas, op. cit., p. 150.

[2] For instance: Defence Organization of Frontiers (1931), Programme of National Defence Works (1934), Armament Plant and Material (1935), Armament, Equipment and Works Advances Fund (1936).

[3] For an account of French War Finance see J. Gauchère, 'Les Mesures financières de guerre' (*Journal des Économistes*, Nov.–Dec. 1939).

primarily to limit margins, and economically was as much related to the British Prices of Goods Act as to E.P.T. The object of the tax was to cut down margins where the additional profits were not due merely to increased output on the one hand, or offset by rising costs on the other. It was thus an attempt to tax pure 'profiteering'. The entire apparatus was based on the turnover tax. No doubt the success which had been made of that tax was an important reason why this method of taxing profits was adopted.

For the purpose of the profit limitation tax, industry was divided into two sectors, one concerned with the war effort, the other with the normal needs of the civil population. In the war sector the tax was imposed at different rates according to the nature of the work done. Very severe rates were imposed on purely financial transactions arising out of government orders and on sub-contracts.[1] Next came transactions in respect of transport and works undertakings, followed by manufacturing transactions. Profits on commission transactions were the most lightly taxed. All of the rates were progressive on successive percentages of turnover (or percentages of commission). In all categories 100 per cent. was reached at a fairly early stage.[2] There was an alternative exemption minimum consisting of the average pre-war profits or the actual turnover multiplied by the pre-war profit on turnover. In the civil sector differential rates were imposed on the three categories of manufacturing, producing, and wholesale concerns; retailers, finishers, banks, insurance companies, &c.; and commission agents, brokers, &c. The rates were slightly milder than in the war sector. They reached 100 per cent. on 8 per cent. of turnover in the first category and on 40 per cent. in the third. The exemption, however, was lower, to allow for the fact that in the civil sector total turnover might well be smaller and yet margins higher. It was fixed at three-quarters of the average pre-war profit, or the actual turnover multiplied by the pre-war rate.[3]

This régime of profit limitation is of no more than academic interest. It is doubtful if its schedules were ever put to the test

[1] 50 per cent. under 1 per cent. of the profit on the total transactions, and 100 per cent. over 1 per cent.

[2] At a turnover exceeding 8 per cent. in the category of works and transport, and exceeding 16 per cent. for manufacturing transactions.

[3] For discussion of the terms of the profit limitation tax see *La Revue Économique et Financière*, *passim*, esp. 16 Dec. 1939.

or any revenue collected. It is a matter of speculation to determine what induced the French to devise such a peculiar tax. The idea that high *rates* of profit are at the bottom of big profits has in the past been widely held. It is doubtful if there is much statistical justification for the belief, but it may well have swayed the Socialist supporters of the measure. In any case the attempt to single out the 'illegitimate' increase in turnover in this way could only be effective if it were possible to measure the increase in real terms, which clearly it is not. The fact that it can only be measured in money terms opens the door for every kind of evasion, particularly when prices are rising.

While France was in the war for too short a period for the effects of her war tax structure to become evident, nevertheless it does appear that the intention was to meet a greater proportion of war expenditure from taxation than had been the case in 1914–18. Revenue for 1940 was estimated at nearly 80 milliard francs, as compared with a pre-war revenue of 44 milliard francs in 1935 and 68 milliard francs in 1938.[1] Loan expenditure for 1940 was estimated at 220 milliard francs. Even if the proportion of collection to assessment had been no higher than usual, the new tax structure should have exhibited a fair degree of elasticity, the more so as it was, in comparison with the British, only mildly progressive.

[1] The comparison is affected by the fact that the normal budget for 1940 included the costs of public works, State railways, and family allowances for the mobilized forces (amounting to about 14·5 milliard francs), but excluded the normal costs of the fighting services. It was thus, on the one hand, more inclusive and, on the other, more exclusive than had been the practice in recent years.

CHAPTER XVII

ITALIAN FINANCE IN THE WAR OF 1914

'It is indeed difficult to make the public grasp the whole complex burden of a tax system', reflects Professor Einaudi in *The War and the Italian Tax System.*[1] More informed inquirers than the general public might be excused for failing to see their way clearly through the maze of taxes, surcharges, monopolies, and pseudo-monopolies of which the Italian fiscal system consisted by the end of the war. Nevertheless, the study of Italian war finance is of special interest for at least three reasons. In the first place, with a direct tax system little more orderly or elastic than the French, Italy did attempt to meet a substantial part of war expenditure out of taxation. This was partly due to the fact that she already had a considerable national debt in 1914. It had been acquired in the Libyan war. Secondly, the very long period during which the Italian economy has been dominated by war—one might almost say continuously from 1911—implies that she has had much experience of, and much cause to experiment in, war finance. Thirdly, Italy has been notable in possessing a group of outstanding economists who since the last quarter of the nineteenth century have interested themselves particularly in the problems of public finance. It is to this circumstance that we owe the possibility as distinct from the desirability of studying Italian war finance in detail.[2]

Until the first decade of the twentieth century the Italian economy had remained remarkably stationary since the time of the Union. The main lines of the tax structure were inherited directly from that period. Roughly half the pre-war revenue of the central government was derived from State monopolies and from taxes on consumption, one-fifth from income taxes, and the remainder from transaction taxes and various miscellaneous sources. Compared with other continental countries the revenue from the income taxes was thus not inconsiderable. The income taxes were of three types—on land, on buildings, and on *richezza mobile*,

[1] L. Einaudi, *La Guerra e il sistema tributario italiano* (Carnegie Series).

[2] Cf. also L. Einaudi, *La condotta economica e gli effetti sociali della guerra italiana* (in the same series).

which included both earned income and income from investments. The last-named was the outcome of Cavour's observation of British methods, and was the most important and most rapidly growing source of revenue. But it shared the fatal weakness of the other income taxes that it was assessed separately on each source of income, and not on the global receipts of the individual.

The Italian tax system was not entirely without a global income tax, but it belonged to the smaller local authorities (Communes). This was assessed on the entire family income, but only in the progressive urban communities of the north were valuation and assessment carried out on modern methods. The main revenue of the Communes was derived from Customs and Excise. The fact that these were the prerogative of the local authorities imposed a severe limitation on the central budget. Besides the Communes, the provincial governments also took a toll of taxpayers' incomes. Their main revenue was derived from surcharges on the national income taxes, but their total needs were very much smaller than the needs of the Communes. As in Germany the limitations on the taxing powers of the central government, imposed by the traditional sharing of the same sources of revenue with the local authorities, determined the form which the war-time tax increases assumed.

As in most countries, an extension of indirect taxes was the first fiscal change of the war. Owing to the demands made on Customs and Excise by the Communes, national tax extensions were necessarily only of small fiscal importance, and the main changes were in the State monopolies. The most obvious major adjustment for the Italians to make was to attempt to turn the income taxes into a fully progressive system. Owing to the peculiar nature of their assessment this proved virtually impossible. The inequality of total burden between individuals similarly placed, except for the distribution of the sources of their income, made rates that were apparently low unbearably onerous in particular cases. The result was that the law was not strictly enforced. The tax on agricultural incomes was particularly difficult to extend, since on the one hand diversities in valuation inherited from pre-union days had never been straightened out, and on the other the local authorities had already imposed heavy surcharges on these incomes. The tax on *richezza mobile* proved little more amenable. It was divided into schedules somewhat analogous to those of

British income tax, but the schedules were taxed at different rates. When progressive scales were applied the result was incredibly complicated.

Besides the increase in the ordinary income taxes several special war income taxes were imposed. The most curious of these was the *centesimo di guerra*, which consisted partly of a 1 per cent. surtax on unearned incomes, and partly of a 1 per cent. deduction from all outpayments of public money. A neat device for collecting revenue without delay or cost of collection, whose only drawback was that it increased expenditure *pari passu*! Then there was a non-combatants' tax—on men of military age exempted from service, and their dependants. For this it was planned to use the valuations of the communal family income tax, but in most cases they proved quite inadequate for the purpose, and the tax was largely inoperative. Later a special tax was imposed on company directors. This also broke down through evasion.

The major attack on war wealth was contained in three measures: (i) a tax on profits 'depending on the war', instituted in November 1915; (ii) a 'levy' on the increase of wealth arising out of the war; and (iii) an 'extraordinary levy' on capital. These two last were both announced in 1919. As finally imposed they were no more than additional income taxes. For the increment 'levy' not all increases of wealth were liable but only those where the taxpayer's income was already subject to the excess profits tax. The rates of this 'levy' were at first progressive, but in 1921 a uniform 100 per cent. was substituted (the *avocazione* or confiscation of war wealth). As we shall see, this became equivalent to raising the rates of the excess profits tax to 100 per cent. The 'extraordinary levy' was intended to be a general capital levy. We shall have to examine later[1] the steps by which these two attempted levies were commuted into annual taxes, based on income rather than on true capital valuation. Here we are concerned with the details of the excess profits tax.

This tax was imposed on businesses only. It was aimed not at excess profits in general but at profits due to the war. There was no machinery for discrimination, however, and in effect it became a normal excess profits tax. It was based on a standard of normal profits, which in practice were held to be the average profits of

[1] See below, ch. xxv.

1913 and 1914, as ascertained for income tax.[1] There was an alternative standard of 8 per cent. on the capital invested, for depressed firms, and this standard was also applied to new firms.

The two concepts of 'ordinary' or 'normal' profit and 'capital invested' were thus of great importance in the Italian tax, but it cannot be said that very equitable arrangements were reached on either point.

One cause of the trouble over 'normal profit' was that in pre-war years many firms had been allowed, for different reasons, to declare their profit at a lower rate than that actually earned. These now naturally wished to use the true profit as the standard. After a long struggle the revenue authorities were forced to give way. Many minor difficulties were also experienced, such as that over the taxation of the profits of co-operatives. When the tax was extended to agriculture a number of these found themselves liable, if they traded with borrowed capital. The authorities were also anxious to tax co-operative 'dividends', but in this they failed completely, as the dividends just disappeared.

The struggle to achieve a workable concept of 'capital invested' is of considerable interest. In the original law it was laid down that the capital invested was to be obtained from the books or other written evidence of the firm. This, it might be assumed, was equivalent to the British method of valuing on the assets side, especially as three months later a ministerial decree declared that the requisite basis was the capital 'effectively employed' in the business. It appears more probable that the revenue authorities in practice used something more like the liability computation. For limited companies, for instance, the correct interpretation was said to be the paid up capital plus reserves. Moreover, at first, when they were working on the assets side, the authorities endeavoured to use the 'internal' valuation of assets, including precautionary writing down. This may well have been due to imperfectly developed machinery for income-tax valuation. This practice was amended later, and the non-written down value supposed to be adopted.

It seems to have been believed by the legislature that in the absence of reliable written evidence, income could be capitalized and used as a basis. It is, of course, only working in a circle to

[1] It was thus mainly a war profits tax, but as the scale was progressive it contained high profits elements in addition to the alternative standard.

attempt to levy an excess profits tax on a percentage basis on this method. But from this idea the revenue authorities developed the practice of determining the 'necessary' or reasonable capital—in relation to the profits made—which they used to prove that the capital must be small, and consequently the taxable excess large. On the other hand, the taxpayers naturally attempted to prove the capital as large as possible. The incentive for this was increased when by a decree of February 1916 company dividends were limited,[1] and companies found themselves with unexpectedly large liquid reserves. The authorities not unnaturally refused to regard these as 'capital invested' after the first accounting period. In respect of other investments the authorities took the not unreasonable course of excluding all but investments in government securities, except in the case of banks where all investments were included.

But as regards the general problem of valuation the legislature seems to have thrown up the sponge at an early stage and to have left it to the revenue authorities to make good their idea of 'reasonable' capital. In the game of pull devil pull baker which ensued, Professor Einaudi is no doubt justified in stating that the excess profits tax was not governed by legal norms or regulations, but was completely arbitrary.[2]

The excess profits tax was levied according to three different scales, all of which were progressive on successive fractions of excess: (i) for manufacturers and dealers—this originally rose from 10 per cent. on profits exceeding 8 per cent. of capital invested, to 30 per cent. on profits exceeding 20 per cent. of capital invested, but it was later raised to a progression ranging from 20 to 60 per cent; (ii) on agricultural concerns, where the original 10 to 30 per cent. progression was maintained throughout; and (iii) for traders, &c. (*intermediari*), where the 'capital invested' standard was inapplicable, from 5 per cent. where profits exceeded pre-war returns by more than one-tenth, to 30 per cent. where they were three times in excess of normal. This scale was later raised to a progression ranging from 10 to 40 per cent.

The rates of the tax on the Increase of Wealth, which, as has been said, was really a surcharge on the excess profits tax, were somewhat steeper. For manufacturers and dealers it was graduated

[1] To the amount distributed before the war, or to 8 per cent. on the nominal pre-war capital (10 per cent. for new companies).

[2] *La guerra*, p. 150.

nominally on the increase in the value of the capital, and when introduced in 1919 ranged from 10 per cent. on the part of the increase between 5 and 10 per cent., to 60 per cent. on that exceeding 50 per cent. For *intermediari* the scales were the same, but the basis was the excess over normal income. The following year the scale was extended upwards, reaching 80 per cent. on an excess of 70 per cent. over pre-war wealth (or pre-war income respectively). Hardly had these rates been announced when they were swept away in favour of the uniform 100 per cent. *avocazione*.

It will be observed that the rates in force during the war period proper, especially when averaged over the whole of the excess, were decidedly low by British standards. It is not surprising that they did little to stem the rising tide of profits. The authorities therefore endeavoured not merely to make the tax retrospective to August 1914, but also to make each rise in rates retrospective. They never succeeded in carrying this out at all in respect of the agricultural section (where in any case there was much complaint from those who were not subject to ordinary income tax), and as far as industry in general was concerned, the uncertainty and disturbance caused by the fear of retrospective burdens was finally found to outweigh the revenue collected, and the practice was abandoned.

As in other countries, the Italian excess profits taxes included certain allowances and deductions. In the first place there was a basic exemption limit, which starting at L. 2,500 a year was gradually pushed up, as the rise in prices made this sum increasingly inadequate for the real needs of small taxpayers who had no other resources. With the introduction of the tax on the increase of wealth the minimum allowance became a global L. 20,000 for the war period, or 5 per cent. on the capital, whichever was the greater. When the *avocazione* was imposed, it became, after much controversy, L. 20,000 per annum. Thus the exemption limit increased *pari passu* with the rates of tax and the rise in prices.

The *avocazione*, although nominally a tax on the increase of capital, was, as has been said, imposed in such a way as to be equivalent to a 100 per cent. excess profits tax. It operated during a period of rapid inflation. The struggle to regulate allowances for special war expenditure and its depreciation, for stocks, and for realized losses, is therefore of particular interest. Up to 1918 there was no system of suspense accounting, but as prices rose and the

probability of immense losses on high cost investment began to cause alarm, the principle of the full balancing of deficiencies was gradually conceded. This made the fixing of reasonable scales of depreciation even more necessary than before.

The first difficulty arose over equipment installed for war purposes which was not likely to be of use afterwards. The first attempt to define the allowance for this was a decree of January 1917 which promised full compensation for the extra cost of construction due to the war, and in addition allowed the capital value to be written down to 20 per cent. of the total cost. This 20 per cent. was to be amortized at the normal rate allowed for income tax. Before long the revenue authorities became alarmed at the generosity of this allowance, and taking advantage of an agitation to include all new investment in the war-equipment allowance, they suggested (at the time of the introduction of the tax on the increase of wealth) that a general allowance of the difference between cost of construction and cost of replacement in 1919 should be substituted. But since prices were at their peak in 1919, this would have been tantamount to withdrawing the concession. This amendment was soon seen to be unworkable. The authorities then attempted to base the allowance on the cost of reconstruction only. Since nobody wished to replace the war equipment, there was a real danger after the introduction of the *avocazione*, that the State would be forced to accept a miscellaneous collection of machines, ships, and other equipment in payment of taxes. It was finally realized that some attention must be paid to the probable future earnings of the concern. But before the matter had been satisfactorily settled the depression was in full swing, and it was clear that much more generous treatment was imperative. The final settlement was virtually a return to the allowance of 1917.

The 100 per cent. *avocazione* aggravated in Italy the difficulty experienced elsewhere[1] that the taxation of increases in the value of stocks and working capital tends seriously to deplete the resources of firms. In Italy the most urgent problem in this respect was concerned with coal, which being mainly imported from Germany in normal times, rose enormously in price. The authorities, hoping to limit the financial responsibility of the Treasury, announced that the valuation for final assessment would be fixed at the prices ruling in June 1920—i.e. when they were still very

[1] For the British experience, see above, p. 82.

high. Once again circumstances proved too strong, and after much wrangling the valuation was fixed at realized or presumed realization prices in the slump.[1]

Taking both the war increases in the normal tax structure, and the special war taxes (including both the tax on the increase of wealth and the *avocazione*, and also the 'extraordinary' capital tax),[2] Italian révenue expanded from L. 2·5 milliards in 1913–14 to L. 19 milliards in 1923–4. It is estimated that during the same period the national income rose from some L. 20 milliards to some L. 100 milliards. The tax burden in relation to the national income thus increased from about 12·5 to about 20 per cent. Among the resources of the national government, income and capital taxes increased about ninefold, and indirect taxes, including monopolies, about sixfold. All these figures are, of course, in money terms and make no allowance for the very large change in the value of the lira.

The experience gained by the revenue authorities during the war infused a new activity and efficiency into the Italian fiscal system. For the first time the right to examine books was obtained, and also the right of fixing liability in cases of change of ownership or liquidation. A considerable degree of this increased thoroughness remained as a heritage from the war. From time to time, however, the authorities overstepped the limits of reasonableness in their zeal for revenue. As the war went on increasing strictness in enforcing payment was attempted. Taxpayers in arrears were restricted in the sale of property, and later it was decreed that they might be declared fiscal bankrupts.[3] These severe measures only recoiled on the authorities. Subsequently concessions were invariably granted, and these frequently reduced the revenue below what a more moderate assessment rigidly enforced might have yielded. An example of a semi-legal type of concession was the postponement of assessment for long periods to suit the convenience of the taxpayer.

War experience also prepared the way for a considerable overhauling of the Italian tax structure. The necessity for dealing

[1] Another instance of a further allowance was that given to shipbuilders for laying down new tonnage. This was later extended to cover any investment in connexion with shipyards.

[2] For details of this, see below, ch. xxv.

[3] Between October 1917 and December 1922, 837 fiscal bankruptcies were declared. After that the policy was abandoned.

with the global income of the taxpayer was at last realized, although still not completely acted upon.[1] After 1922 the Fascist régime returned to a policy of safety first, as a reaction from the experiments of the war era. The burden of direct taxes was reduced, and chief reliance was placed on a general sales tax. The result, if somewhat regressive, was at least more productive of revenue.

[1] See below, ch. xxvi.

CHAPTER XVIII

SCANDINAVIA (1914–18)

ALTHOUGH they were not belligerents, the Scandinavian countries found their economic structure and their finance seriously disturbed by the war of 1914–18. Prices of imports rose rapidly as a result of shipping difficulties. But the most important disturbing factor was the insatiable demand of Germany for particular products—above all for Swedish iron and Danish butter. The result was, on the one hand, a rise in the price of necessities which made rationing and the subsidization of certain foods inevitable; and on the other the emergence of war profiteering. The economic change was thus in many ways similar to that experienced in the belligerent countries, with the important difference that there was no war destruction of equipment, so that expenditure and borrowing were on a much smaller scale. This difference was particularly marked at the end of the war. The intensity of foreign demand collapsed with the end of hostilities. There was only a moderate 're-stocking' boom to take its place, prices fell and tax receipts diminished abruptly.

Broadly speaking, the war experience, and the financial measures taken to meet it, were very similar in the three countries. Denmark, where there was in 1914 a strongly Left government, immediately launched out on a wide programme of consumption subsidies. To cover the cost of these she was first in the field of any country in imposing excess profits taxation. In Sweden, in the later stages of the war, the situation was complicated further by the failure of the government to pay sufficiently high prices for the foodstuffs it acquired for distribution, to stimulate agricultural output. There was, therefore, a large turnover of labour from agriculture to the heavy industries, causing an aggravation of excess profits on the one hand, and of the scarcity of foodstuffs on the other. Norway, like Britain, was faced with the problem of the enormous profits made from the sale of ships at highly appreciated prices, which being in the nature of capital transactions, slipped through the net of excess profits taxes. The Norwegian solution was to impose an *ad hoc* tax on sales of ships. This operated for three years from 1917, and brought in a total revenue of Kr. 60 millions.

Although the economic experiences of Sweden during the war have been very fully described,[1] her financial effort has only been treated in outline. In Norway, after the first year of war, the government ceased to present formal budgets. Essential statistics are, therefore, also lacking in this case. Danish experience, however, has been relatively fully described in the Carnegie Series.[2]

The main fiscal innovation in all three Scandinavian countries was an excess profits cum excess income tax, levied on companies and individuals. In Denmark this was introduced in May 1915. Sweden followed in June, and Norway in August of the same year. The taxes were nominally levied only on additional profits (or incomes) due to the war, but the onus of proving that an addition was not due to the war rested on the individual taxpayer. In all cases average pre-war income was taken as the standard, and there was a minimum exemption limit, both for individuals and companies. Both sections of the taxes were progressive, at least after the first year. The usual plan was to graduate the tax according to the proportion of the total excess, not on successive fractions of excess, as was common elsewhere. In no case, however, was the progression at all steep. The 24 per cent. charged on an excess of over Kr. 450,000 imposed in Sweden in 1916 was exceptional.

It is worth following Danish policy in some detail, since it was first in the field, and also met with considerable success. Without the exceptional economic advantages of Sweden, Denmark managed nevertheless to give very large subsidies for foodstuffs, and also substantial additional public assistance. About two-thirds of the cost of these was covered by the special war taxes. The first war budget, in May 1915, raised the ordinary income and property taxes, including death duties, and imposed the 'Extraordinary income tax on war profits'. Individuals were liable in the first place, but a company tax was foreshadowed in the original announcement. The rate was a flat 10 per cent. on excess over the average of three pre-war years, with a minimum exemption limit of Kr. 8,000. Deductions were, however, allowed—of Kr, 7,000 on an excess of Kr. 8,000, diminishing to Kr. 1,000 on an excess of Kr. 100,000, so that there was in fact an element of progression. At the end of the year stamp duties were also raised.

The real expansion in war taxation was, however, in 1916. The

[1] Cf. Heckscher, *Sweden in the World War.*

[2] Cf. Cohn, *Danmark under den store Krig.*

exemption limit for individuals was lowered to Kr. 6,000, and a definitely progressive scale introduced, rising to 25 per cent. on an excess income of over Kr. 900,000. All company profits were liable to the tax if they both exceeded the pre-war average and a return of 5 per cent. on the capital invested. The rates were progressive, on the total excess. They ranged from 5 per cent. on returns between 5 and 8 per cent. on the capital, to 20 per cent. on a return of more than 20 per cent. New companies were subject to a flat rate of 10 per cent. if profits exceeded 5 per cent. on the capital invested. The same year a new surtax on property over Kr. 24,000 and incomes over Kr. 8,000 was introduced, as an alternative to the excess income tax, and in fact eventually took its place. Later in the year stamp duties were doubled. The following year the progression of the excess income tax was stiffened, reaching 30 per cent. on incomes of over one million kroner, and there were rises in the rates of most of the normal taxes. In the spring of 1918 the highest rate of excess income tax became 35 per cent., but as the income of 1915/16 was allowed as an alternative base to the average pre-war income, revenue fell off in favour of the surtax on capital and large incomes, and excess income tax began to fade out of the picture. The reason for this change was stated to be the irrelevance of pre-war income in view of the price-changes that had taken place. Later in the year there were further increases in indirect taxes, such as postal and railway charges, and in the ordinary property tax. The climax of war taxation was reached in 1919, when an anticipation of liability was exacted, the 'Fifth Quarter's Tax', bringing the total tax revenue to more than five times the pre-war figure.

Although Denmark's fiscal effort was relatively the greatest, the final figures for the three Scandinavian countries show remarkable similarity, both in the growth of tax revenue and of the national debt. Denmark began the period with a debt of Kr. 360·9 millions. By 1920 it had risen to Kr. 926·2 millions. Her tax revenue expanded from Kr. 99·7 millions in 1914 to Kr. 575·3 millions in 1919. Norway[1] had a pre-war debt of Kr. 357·3 millions and a tax revenue of Kr. 90 millions. In 1920 the national debt had reached Kr. 1,129·6 millions and went on growing until 1925, when it reached Kr. 1,731 millions. By 1920 her tax revenue was Kr. 510 millions. Sweden entered the war period with a debt of

[1] Cf. Keilhau, *Norway in the World War.*

Kr. 648·3 millions, which had reached Kr. 1,496·5 millions by 1920, while her revenue had expanded from Kr. 198·3 millions to Kr. 797·3 millions in the same period. While the rise in the national debt was not so great as to constitute any obstacle to future borrowing in any of the three countries, the war left them with a substantially higher revenue in real terms,[1] and also an improved tax administration, an experience they shared with most of the belligerents.

[1] Thus the Swedish revenue settled down at an average of Kr. 500 millions, and the Norwegian at Kr. 300 millions.

CHAPTER XIX

THE BRITISH DOMINIONS

THE Dominions have inherited the fiscal traditions of the Mother Country. Consequently their experience of war finance is much more closely parallel to the British than that of any other country which we have examined.

The main difference between the tax structures of the Dominions and of Britain has always been their greater reliance on indirect taxes. This difference was very marked in 1914, but it still exists. The explanation of the difference is partly historical. The main lines of the Dominion tax structures were fixed by the Mother Country at a time when British income tax was still regarded as a temporary measure. The Dominion industries thus grew up behind tariff walls which both they and the governments were loth to see reduced. And in spite of increasing industrialization agriculture still plays a predominant part in the Dominion economies. It is notoriously difficult to get direct taxes out of farmers. Moreover, since all the Dominions except New Zealand are more or less organized as federations, they suffer from the disability which we have so frequently encountered elsewhere. When the central governments required to expand their revenues in 1914–18 they found that the constituent members—states or provinces—had already eaten into the field of direct taxation, and in some cases were levying not inconsiderable income taxes. The bases and rates of these local direct taxes were not sufficiently uniform to make an equitable foundation for a central surcharge, even if the local governments had been willing to share the revenues freely. On the other hand, the central governments were not in a position to raise an adequate revenue by an income tax of their own until they had built up the necessary administration.

In these circumstances the excess profits tax offered certain advantages in spite of the relatively small industrial development. It was a direct tax in which there were no vested interests. Further, since the war period was one of prosperity and great industrial expansion in the Dominions, the war profiteer was not long in making his appearance. There were thus strong social and economic arguments in favour of taxing profits—sufficient to outweigh

the disadvantages of want of fiscal experience. The Dominion excess profits taxes in the war of 1914–18 were not of much fiscal importance, and in the case of New Zealand the experiment was judged to be unworkable and abandoned after a year. Nevertheless, the experience gained by the central administrations during the war period was of the highest importance. Although difficulties still remain, central income taxes are now universal, and this time it has been a much simpler matter to expand central revenues. The difficulties which sometimes hampered excess profits taxation in the last war have now been largely removed; so that in this war all the Dominions are working excess profits taxes.[1]

The Dominion excess profits taxes in the last war were, as was only to be expected, more or less close variations on the theme of E.P.D. Their plans for the present war also draw largely on British experience as well as on their own. As a result the taxes have mainly been simple and workable. Definitions of capital, profits, &c., have largely been taken over intact. Australia, and later Canada, have also adopted the plan of establishing an independent Board of Referees to secure flexibility and the equitable treatment of hard cases. The similarity between the excess profits taxes of the Empire[2] implies, of course, that we should not expect to find any striking theoretical or administrative novelties in the Dominion taxes. But there are a number of significant differences in detail. Some of these clearly reflect socio-political or economic conditions peculiar to the particular Dominion. For others there is no obvious explanation, and it may be that they are accidental and that their significance has not been observed.

In the last war only a small part of Dominion expenditure was covered out of revenue. In the present war the indications are that the proportion of borrowing will be smaller. In view of the greater difficulty of collecting revenue, however, it is not likely that the proportion of taxation to borrowing will be so high as in Britain.

CANADA was the first of the Dominions to impose an excess

[1] In the spring of 1940 British India became a recruit to excess profits taxes. A war profits tax at a flat rate of 50 per cent. was announced.

[2] The existence of Dominion excess profits taxes raises in an acute form the question of double taxation. In the last war the first measure to eliminate this was an agreement with New Zealand that only the higher of the two taxes should be imposed. This was generalized by the British Finance Act of 1917. The matter is dealt with in section 30 of the Finance (No. 1) Act, 1940.

profits tax in the war of 1914–18, and the last to remove it. It ran from 1916 to the end of 1920. Until 1917 there was no Dominion income tax. The difficulty which thus arose of ascertaining pre-war profits was probably one of the reasons which decided the Canadian government to adopt the high profits principle in the Business Profits tax. No doubt opinion was influenced also by the feeling that Canadian industry had been making very good profits indeed in the piping pre-war days. As in America a little later, the high profits principle had a strong social appeal. The standard chosen in Canada was 7 per cent. on the capital employed for companies and 10 per cent. for non-incorporated businesses. No attempt was made to extend the tax to farming or stock-raising. Small firms, with capital of less than $50,000, insurance companies and certain public utilities[1] were also exempted.[2]

Originally the business profits tax was imposed at the very modest rate of 25 per cent., but as time passed it was stiffened up. In 1917 a simple progressive scale was introduced, profits of between 15 and 20 per cent. paying at the higher rate of 50 per cent. and above that level at 75 per cent. The following year the exemption limit was brought down to $25,000. The conditions thus established remained in force until the end of 1919.[3] For the calendar year 1920 some relaxation was introduced. The first 10 per cent. of profits was exempted for all firms. The scale then ranged from 20 per cent. on the fraction of profits representing a return of between 10 and 14 per cent. on the capital, to 60 per cent. on the fraction of the return over 30 per cent.

The total receipts of the Canadian excess profits tax were just under $200 millions, of which only $111 millions had been collected during the currency of the tax. During the actual period of the war only one-sixth of the total revenue was collected, the main part, as usual, being gathered in in the early post-war years. Total war expenditure during the currency of the tax amounted to $1323·7 millions.

The Canadians do not seem to have been satisfied with their

[1] Where the capital was more than 90 per cent. owned by a province or other local authority.

[2] Concerns which would otherwise have been exempt were liable to tax if engaged on war production to an extent of 20 per cent. or more.

[3] Except that the rate for small firms (with capital of between $25,000 and $50,000) was dropped to 20 per cent. but firms engaged in manufacturing or dealing in war material were liable to the tax whatever their size.

business profits tax.[1] The new excess profits tax is fundamentally different in principle. It is also imposed in a very different economy. Industrialization has made great strides. The Dominion income has nearly doubled since 1913 and the population has expanded from eight to eleven millions. The Dominion revenue authorities are now fully competent to deal with a war expansion of revenue. In normal times income tax accounts for 30 per cent. of central revenue.[2]

In the present war the Canadians were ahead not merely of the Dominions, but of the whole Empire. Proposals for an excess profits tax were introduced in September 1939, thus a month in advance of Britain. It would appear, however, that by September the administration had not yet made up its mind what type of tax it really wanted. In effect two completely different taxes were proposed: (1) on a high profits basis with a standard profit of 5 per cent. on the capital invested and progressive rates ranging from 10 per cent. on a return of 5 per cent. to 10 per cent. on the capital, to 60 per cent. on one of over 25 per cent.; or, at the option of the taxpayer, (2) on a war profits basis of the average of 1936–9 profits, with a flat rate of 50 per cent. The Bill introduced in the early months of the war was, however, as in Britain, more in the nature of a tentative suggestion than of a definite proposal.

In Canada as in Britain, during the first winter of the war expenditure persistently lagged behind estimates. Monthly war expenditure of some \$58 millions had been anticipated, but up to the end of July the monthly average was below \$29 millions.[3] There was hence no difficulty in or objection to financing the initial war effort out of existing taxes (including increases in income and corporations taxes) with the addition of some borrowing.[4] The first real war budget was not introduced until June 1940. It then included further heavy increases in the rates of personal income tax and in some established indirect taxes, as well as several new

[1] This is borne out by a contemporary critic, F. O. D. Skelton, *Canadian Federal Finance*, 1918 (Kingston, Ont.).

[2] Like many of the United States, Canada now also leans heavily on the sales tax. It likewise accounts for 30 per cent. of Dominion revenue.

[3] By August, however, expenditure was fully up to the estimate.

[4] The banking system advanced \$200 millions in November 1939, and a further \$250 millions in early 1941. Two small war loans (\$200 millions and \$300 millions) were floated in 1940, and a larger one (over \$740 millions) in June 1941. War savings certificates are also on sale.

levies.[1] The excess profits tax reappeared in a new and simplified form, embodying only the second (War Profits) option of 1939, with a rate of 75 per cent.

In the new Canadian excess profits tax capital is now computed on the assets side, the assets being taken at cost less depreciation. Intangibles are excluded unless they have been purchased. Changes in capital employed are evalued at the ends of accounting periods, as in the British E.P.D. An allowance of $7\frac{1}{2}$ per cent. change in the standard is made in respect of changes in capital, both for additions and withdrawals. Debts, and dividends from other Canadian companies, are in all cases excluded. War income taxes are allowed as a cost. For one-man firms, partnerships, and 'personal service corporations'[2] it is permissible to make a further deduction of a proportion of total income tax equal to the proportion which the profits of the concerns bear to the aggregate incomes of the proprietors. It is evident that great care has been devoted to the drafting of the clauses concerned with the computation of capital, but since the tax is now wholly on the war profits basis, presumably the concept will not be of such vital importance as it was in the earlier Canadian tax. These changes have brought the Canadian tax more closely into line with the British tax, except that there is no suspense accounting. The wide powers of the Board of Referees are reminiscent of E.P.D. rather than of E.P.T.

It is worth noting that the new tax is considerably wider in scope than the old one. It applies to all business and trade carried on in Canada whether registered in the Dominion or not. (Where a company is registered outside, only that portion of its profits attributable to its Canadian activities will be liable to the tax.) The inclusion of foreign owned concerns is of great importance in view of the rapidly increasing number of American firms with Canadian branches. It is equally significant that Canada means this time to tax the profits of the farmers.

While its greater simplicity is no doubt one reason which decided the Canadians to switch over from a high profits to a war profits tax, the difference between Canadian industrial experience in the first and third decades of the century may also have played

[1] Including a defence tax of 2 per cent. on all (single) incomes in excess of \$600 (\$1,200 for married persons and an allowance of \$80 per child); and a 10 per cent. exchange defence tax on non-British imports.

[2] Cf. the British 'Director controlled' company. For American usage, cf. above, p. 123 n.

a part. In recent years not a few Canadian firms have been more conspicuous for their low than for their high profits. This explanation is also suggested by the fact that a Board of Referees has been established for the first time. Besides determining an appropriate standard for new firms, they have the explicit duty of making arrangements for firms which may have been depressed in the standard period. A further flexibility provision, which reflects the growing importance of Canada's war industries, is the clause which empowers the Governor in Council to provide by regulation for the depreciation of plant or equipment built or acquired to fulfil orders for war purposes. The only remnant of the policy of taxing high profits—if it may be called so—is the simultaneous imposition under the same Act of an alternative proportional tax on total profits, similar to the British N.D.C. This was imposed at the rate of 12 per cent. for 1940, rising in 1941 to 22 per cent. for incorporated and 15 per cent. for unincorporated firms. As in Britain the taxpayer is assessed to whichever alternative gives the higher liability.

During 1940 and 1941 Canada enjoyed a war boom; in spite of the war expenditure, consumption goods industries increased, instead of diminishing, their activities. The budget of 1942 has been clearly designed to put a check on this development, being parallel, in many of its provisions, to the British budget of 1941. Both indirect and direct taxes have been heavily increased, and the excess profits tax has been raised to 100 per cent. As in the British case, 20 per cent. will be returnable after the war, and similar 'compulsory saving' provisions operate with respect to income taxes.

AUSTRALIA in 1914 already possessed a small federal income tax, but the main source of Commonwealth revenue was customs duties. The excess profits tax which came into force in September 1917 was an almost exact copy of E.P.D. There was an alternative standard of average pre-war profits or 10 per cent. on the capital employed. A flat rate of 50 per cent. was imposed retrospectively on the profits of 1915–16. After that date the rate of 75 per cent. applied to all profits up to 30 June 1919. The receipts from the first Australian excess profits tax were not large. During the war period only £1·9 millions was collected. In 1918–19, when the tax was in full swing at the higher rate, it provided less than a thirtieth of total revenue. There is nothing much of interest to be

learnt from the first Australian excess profits tax. But that is not at all the case in the present war.

The Commonwealth tax structure has become considerably stronger since 1914, but the direct taxes remain principally in the hands of the States. The different rates and bases of the State taxes still make them unsuitable for the foundation of a high-rate federal income tax. In normal times only 2 per cent. of the Commonwealth tax revenue is derived from its income tax. On the other hand, Australia has for some years endeavoured to follow an integrated monetary policy, consciously directed towards maintaining industrial activity and employment. The government's declared action in the autumn of 1939 continued this policy. It was announced that the full fiscal plan to meet the needs of the war would be postponed until employment and the national income had expanded sufficiently. Accordingly, in the early stages, war expenditure was financed by borrowing directly from the banking system. A very successful savings certificate scheme was introduced, and in the spring of 1940 two internal loans of about £A20 millions were floated.

The first comprehensive war budget was introduced in May 1940. Proposals included an all-round increase in existing taxes, a small levy on undistributed profits,[1] and an excess profits tax. Whereas in the last war Australia followed Britain in imposing a hybrid excess profits tax, in the present war she appears to have swung over completely to the high profits principle. As imposed in 1942[2] the standard was 8 per cent. on the capital employed. Profits of £A1,000 (a return of 8 per cent. on £12,000) were exempt. The tax does not apply to non-incorporated firms, co-operatives, and firms employing only a small amount of capital. The method of assessment is based on the existing income tax machinery, and is closely in line with British practice. Debts are excluded, and federal and State income taxes are allowed as a cost. Where assets stand in the books of a company at a value differing from the value obtained on income tax methods (broadly speaking cost, less depreciation according to market prices), they will be adjusted accordingly. The Australian tax thus looks like being the first example of a high profits tax based on the British method of capital computation on the assets side.

[1] 1 per cent. on 75 per cent. of net profits.

[2] For later amendments see note on next page.

The change over to a high profits principle may be based on no particular argument, or it may implicitly be the effect of the frequent periods of Australian prosperity during the inter-war period. In any case the safety valve of the Board of Referees will continue to function in the present Australian excess profits tax as it did in 1917–19. The Board of Referees has powers roughly similar to those of the British E.P.D. era—thus somewhat wider than under E.P.T. It can decree an adjusted standard where it does not appear that the normal method of computation represents the true capital employed. It can also decree a higher standard for a company (or for an organization representing a class of companies), where there is an exceptional degree of risk.

The Australian budget, issued in September 1941, provided for a total expenditure of £A319 millions. Little more than a month later this was superseded by the budget of the Labour Government, which called for total expenditure of £A324·97 millions,[1] of which £A221 5 millions was in respect of the war effort. Additional revenue is to be obtained from personal income tax, from estate duty, and from a small increase in indirect taxation, but the most important source of new revenue is company profits. The ordinary corporation tax is increased from 2*s.* to 3*s.* in the £, to bring in an additional £A4·5 millions. The standard for the excess profits tax is reduced to 4 per cent. on the capital employed, and the range of rates increased so that they run from a minimum of 6 per cent. on an excess of 1 per cent., to a maximum of 78 per cent. on that part of the excess which represents a return exceeding 16 per cent. on the capital employed. It is estimated that this increase will produce £A4·75 millions. Even so, the rates are still moderate compared with those in force in Britain and Canada.[2]

The NEW ZEALAND administration being more closely integrated than in the other dominions, the direct taxes of the central government were already of importance before 1914. Besides income tax and death duties a not inconsiderable part of the revenue was derived from taxes on land. Nevertheless two-thirds of the revenue came from customs. During the war all existing taxes were heavily increased. The tax revenue was doubled and the share of income tax rose to 50 per cent.[3] Thus although she failed

[1] Cf. *The Times*, 30 October 1941.

[2] Cf. T. W. Swan, 'Australian War Finance and Banking Policy', *The Economic Record*, June 1940, for a good account of Australian policy. Cf. also *The Economist*, 10 Aug. and 14 Sept. 1940, and D. F. Kerr, 'Australia's War Effort', *The Banker*, Sept. 1941.

[3] This is partly explained by the fact that the tax on the income from land was merged with the general income tax.

to work an excess profits tax New Zealand's war fiscal effort was by no means negligible.

The abortive New Zealand excess profits tax was imposed in 1916, retrospectively for the year 1915–16. Like the Australian tax it was a close copy of E.P.D. The alternative standard allowed a choice of the average of pre-war profits or a return of 7½ per cent. on the capital employed. Instead of a separate standard for private firms a small addition to the standard was allowed as remuneration for the taxpayer's personal exertions.[1] Losses in the three years ending 31 March 1915 were to be taken into account, and there was also provision to relieve hardship in certain specified cases. No tax was payable on profits of under £300, and in any case tax due was not to exceed the amount by which profits exceeded £300. Where the pre-war profits standard was inapplicable the 7½ per cent. basis was used, and this percentage was also employed for changes in capital. Apparently, however, the British tax did not prove suitable to New Zealand conditions. It was judged impossible to administer it with equity, and after a year it was abandoned in favour of an additional surcharge on the income tax. No doubt the difficulty of assessing and collecting farming profits was a big stumbling-block.[2]

In spite of the failure of the excess profits tax in the war of 1914–18, New Zealand intends to give it another try. In the first year of the present war New Zealand's needs were estimated at £NZ37·5 millions, of which it was hoped to raise about two-fifths by taxation, mainly by increasing the rates of existing taxes. In October 1940, an excess profits tax, at the flat rate of 60 per cent., was introduced. It is imposed on profits which exceed the highest profits earned in any of the three years ending March 1939, or exceed the average profits earned in those years by more than 30 per cent. (whichever figure is the lower). There is an alternative percentage standard of 6 per cent. Income tax is allowed as a cost.[3]

[1] Or such sum, not exceeding £600, as the Commissioner of Taxes should consider appropriate.

[2] One reason advanced for the abandonment of the tax clearly rested on a misunderstanding. The *Official Yearbook, 1919*, stated 'The excess profit duty levied in 1916 was not re-imposed in 1917, experience having brought to light almost insuperable difficulties in ascertaining exactly the actual profits resulting from the war'. There appears to have been nothing in the legislation calling for such an ascertainment.

[3] At the same time the floating of a semi-compulsory war loan was announced.

The UNION OF SOUTH AFRICA had in 1914 already some experience in taxing profits—in the gold-mining industry—but the major part of the revenue was derived from customs duties. When the first general income tax was imposed in the fiscal year 1914–15 some of the mining levies were merged with it. It consequently attained considerable fiscal importance. An excess profits tax was imposed in 1917.[1] It was based on the war profits principle, with the profits of the year ending 30 June 1914 as standard. The first £500 of excess was exempted. Profits of both incorporated and non-incorporated firms were liable, from the fiscal year ending 30 June 1917 to 30 June 1920. The tax was imposed at the uniform rate of 25 per cent. The greater part of the revenue was collected after the war period. Up to 1919 no separate figures of receipts from the excess profits tax were published. In the next three years, on the average, receipts amounted to £1·4 millions. Total tax collection in the same years averaged £24 millions. Receipts from the South African excess profits tax were thus somewhat larger both in cash and in proportion to total tax revenue than in Australia.

In the years leading up to the present war South Africa's budget was of the order of some £SA45 millions, of which about 42 per cent. was raised by direct taxes, including the taxation of gold-mining.[2] The budget proposals for the fiscal year 1940–1 prepared for a considerable war expansion, bringing total expenditure up to nearly £SA60 millions. A supplementary budget subsequently raised this estimate to £SA92 millions. Among the additional taxes imposed was an excess profits tax of the hybrid type, bearing a flat rate of 50 per cent. It is based on an alternative standard of pre-war profits[3] or a statutory percentage.[4] Capital is valued

The prospectus suggests that individuals and companies are expected to subscribe at least a sum equal to their last income-tax payment (with an allowance of £NZ50 for individuals and £NZ70 for companies). For the first three years it is proposed to pay no interest, and thereafter 2½ per cent. The duration of the loan is to 1953.

[1] By the Income Tax (consolidation) Act. The Union income taxes thus became four—income tax, supertax, dividend tax, and excess profits tax.

[2] After the departure of the Union from the gold standard an excess profits tax was imposed on the gold-mining industry. It was based on the profit per ton milled in Nov.–Dec. 1932, and was in force from 1933 to 1936. Besides bringing in a good revenue, the tendency to postpone profits had in this case the useful function of encouraging the working of low-grade ore.

[3] Either the average of the three years ending June 1939, or the last year alone.

[4] For non-incorporated firms 12 per cent. with a minimum of £SA1,000, 8 per cent. for companies.

according to the British method. The British method of suspense accounting with deficiency payments is also adopted. The Act contains elaborate provisions for preventing evasion through managerial remuneration or fictitious transactions. There is a minimum exemption limit of £SA500 for non-incorporated firms and £SA250 in the case of companies. The tax covers the whole field of trade and industry with the exception of the gold and diamond-mining industries, which are by the same Act subjected to a special war levy.

In 1941 the rate of the excess profits tax was raised to 13*s*. 4*d*. in the £, and there for the present it remains. But it is clear that there has been dissatisfaction with this relative leniency, though for a different reason than in other countries. In the years before 1939 South Africa, unlike most other countries of the world, was enjoying a pronounced boom (due of course to the high price of gold); consequently, the standard pre-war profits (on which the excess profits tax was based) were in many (perhaps most) cases well in excess of what might reasonably be considered normal. In these circumstances the case for introducing some element of the High Profits principle into the tax was more than usually strong, and it is not surprising that the South African government should have been unable to resist it. It would appear that the authorities were well aware of the defects of the High Profits principle, but have been unable to rely entirely upon the alternative method of taxing high profits through income taxes, because of the important share in South African profits which is transferred abroad, and is therefore only partially amenable to South African income taxation. Thus it is impossible to withhold some sympathy from the Special Levy on Trade Profits introduced in 1942. This levy falls on all profits in excess of 8 per cent., no matter what rate was earned before the war. The rate of tax 'is to vary according to the relation between the rate of war-time profit and the rate of profit enjoyed as the pre-war standard, with a maximum rate of 6*s*. 8*d*. in the pound where a pre-war standard profit in excess of 8 per cent. has been fully maintained, and a lower rate where the trading results have been relatively less favourable but profits in excess of 8 per cent. have none the less been made'.[1] The concession to the High Profits principle has been kept by this ingenious device within creditably narrow limits.

[1] *Round Table*, June 1942, p. 427.

PART V
THE CAPITAL LEVY—GENERAL CONSIDERATIONS
CHAPTER XX
THE EQUITY OF A LEVY

A CAPITAL levy, as the term seems generally to be understood, is a direct tax of such magnitude as to fall upon the capital of the taxpayer. It need not be assessed upon capital, though it usually will be; the important thing is that the levy is too large to be paid out of income. Having once paid such a tax, the taxpayer's capital must be reduced; in all probability his future income will be reduced as a consequence; thus his future capacity to pay taxes will be reduced. A capital levy is not capable of being adopted as a regular part of a fiscal system; it is only suitable for use in special emergencies.

On this definition, an income tax at a rate of more than 20*s*. in the £ is a capital levy;[1] but there are many sorts of capital taxes, assessed upon capital, but payable out of income, which are not. Taxes on particular sorts of capital or property (land, houses, and so on) are a well-established feature of most fiscal systems; they are of course paid out of income, and expected to be paid out of income. The same would very probably be true of the general tax on capital which has sometimes been proposed as an alternative to the capital levy, and which we shall have to discuss at length later on. Death duties are more of a border-line case. They are often much too large to be paid out of the income of the legatee; so they are a capital levy so far as the particular estate is concerned. But the number of estates liable to death duties at any particular time is always relatively small; sufficient funds to pay the tax can therefore be provided out of the savings of other people, which are made available for this purpose by the sale to the savers of parts of

[1] Such an income-tax could not be incorporated into a regular tax system. It could only be levied upon income which had already been earned at the time the tax was imposed; otherwise it would yield no revenue. It is always possible to avoid having an income, if to have one becomes a definite disadvantage. Companies, for example, would decline to distribute dividends, since it would be more in the interest of their shareholders for them to build up reserves, which could be distributed as soon as the authorities had seen the foolishness of their ways, as must inevitably happen.

the taxed estates. Though death duties are laid upon capital, socially they are paid out of income rather than capital. They do not raise the special economic problems of an emergency levy.

The sorts of emergency for which capital levies have been mainly used are two: one previous to the outbreak of war, or during it, the direct financing of war preparations; the other after the end of a war, the redemption of war debt. Among those levies which are described in this book, the Italian and Hungarian levies of 1937–8 are examples of the first type; the German, Czech, Austrian, and Hungarian levies of 1919–20 are, at least in intention, examples of the second. It is the second type of levy which has been most widely discussed in England; the very idea of a capital levy is closely associated in the English mind with the war-debt problem. But of late there has been some discussion of the possibility of a levy as a means of war finance; consequently, although the case for a war-time levy seems to be much less good than the case for a levy after the war, we shall not exclude this application altogether from our discussion.

The choice between taxation and borrowing as means of financing a war does not, as is well known, mean that there is very much choice for the community as a whole whether it will pay for the war by present or by future sacrifice. A war has to be paid for by present sacrifice, excepting in so far as it can be financed out of external borrowing, or out of the sale of foreign assets, or out of the using-up of accumulated stocks. But when it comes to the distribution of the war burden there is a further alternative. The maximum which any individual can pay currently is his whole income, minus what is necessary for him to live on; it is only possible to make him pay more than this in the sense that arrangements may be made for diminishing his future income, and in return for a promise of some of that future income being transferred to them, other people may be induced to make voluntary current sacrifices, for which they are offered a future reward. This is substantially what happens if war costs are met by borrowing; it is also what happens if they are met by a capital levy. It is absolutely impossible for the taxpayers subjected to a levy to meet their obligations in full by restricting consumption; if they spent nothing at all, it would not be sufficient. They are obliged to sell off assets, and so reduce their future incomes. Just the same thing happens

if the State borrows the money, and meets the interest charges by recurrent taxation on the people who would have paid the levy.

Thus the significant comparison is not between a capital levy and other sorts of taxation; it is between a capital levy and finance by loan. The same situation arises at the end of the war. Either the war debt can be left unrepaid, interest charges being met out of current taxation; or the debt can be repaid out of a capital levy. In each case the net incomes of taxpayers are reduced, probably over a long period. But in one case the distribution of the deduction is decided all at once, at the time when the levy is imposed; in the other case the State has to raise a certain sum every year to cover the interest due, the way in which the burden shall be divided among taxpayers being decided afresh from year to year.

When the matter is looked at in this way, one of the most serious objections to the levy alternative comes out very clearly. If a sum of one million pounds per annum for a number of years is to be raised from a group of taxpayers by an income tax, or other recurrent tax, the distribution of the tax among the taxpayers can be revised every year for which the tax is levied; it is indeed automatically revised for changes in their relative wealth as soon as it is assessed on some index of their respective wealth in each year. But if 25 or 30 millions (whatever we take to be the capitalized value of one million per annum) is raised from the same group of taxpayers at one swoop by a capital levy, the distribution of the burden among those liable has to be settled once and for all. The total sum raised from the whole group may be no greater (reckoned as an annual charge) than the total sum raised by the annual tax; but whereas the annual tax does allow for changes in relative riches (such as are bound to occur as time goes on) the capital levy does not. Consequently its effects may prove to be extremely inequitable after a little time has elapsed. Of course this is not a fatal objection to the levy plan; but it is desirable to choose the time and the form of the levy in such a way as to reduce this danger to a minimum.

Just because a levy has to be made once and for all, its effects extending however over a long period, low standards of equity are less tolerable in the case of a capital levy than they are with an ordinary tax. Yet there are several reasons why the attainment of a high degree of equity in the construction of a levy is extremely difficult. For one thing, a capital levy is only imposed

upon people with capital; people with high earned incomes escape from it, although they may be as well off as the people who are liable. A man with an earned income of £10,000 a year does in fact enjoy much the same degree of wealth as a capitalist possessing a capital of £200,000 or more; if the second person is to be subject to the levy, why not the first? Consciousness of this gap has often led to proposals for the inclusion of high professional incomes in a capital levy, for the taxing of 'brain capital' as it has been called. There is in fact an absolutely decisive reason why brain capital cannot be taxed in the same way as material property. A levy of £20,000 would take away 10 per cent. of our capitalist's capital, leaving him with an income which would be reduced, but not devastatingly reduced; a similar levy imposed upon 'brain capital' would force the professional man deeply into debt, and though he could continue to pay the interest on that debt without difficulty so long as his earnings remained on the same level, a serious fall in those earnings (such as might easily arise from some personal cause such as ill-health) would reduce him to penury or bankruptcy. This danger is in fact so obvious that no one, excepting the government itself, would advance him the loan in the first place. It is almost impossible to tax professional incomes except by an annual tax. A capital tax has monstrous results when there is no saleable capital.[1]

The impossibility of taxing 'brain capital' has been generally appreciated by all those actually responsible for drafting capital levies; but there is another application of the same principle which has been less well observed in practice. It has been a common practice of some of the cruder levies to make extensive use of the method of valuing capital by capitalizing income, thus avoiding the administrative difficulties of direct valuation. For example, in the Italian levies of 1937–8 land and houses were valued by capitalizing the income from them at 5 per cent., private businesses by capitalizing the income from them at 8 per cent.[2] This reduces the capital levy to a capital levy on income. If income is capitalized

[1] It is, of course, perfectly possible to impose a special tax on earned income at the same time as a capital levy is imposed; but unless it is very much heavier than the levy in its effect on income, or unless it is a permanent tax, it will not have an equivalent weight to that of the levy.

[2] Some variation in the rates of capitalization used for different sorts of property is, of course, extremely reasonable; but it is not so easy to establish a system of discrimination on objective economic grounds, without suspicion of favouritism or log-rolling.

at 5 per cent., and this 'capital' is subjected to a levy of 10 per cent., the result is nothing but a special income tax at the rate of 40*s.* in the £. Such a tax is liable to the same sort of objection as a levy on 'brain capital'. The income derived from a capital asset in a particular year may be abnormally high or abnormally low; since the weight of the levy will continue to be felt for a long period of years, the capitalist who happened to have an abnormally high income in the year of the levy will be overtaxed by a levy based on income, one who had an abnormally low income will be undertaxed. It is true that people cannot be taxed now according to what their incomes will actually be in future years; even the best-informed revenue authority cannot know what those incomes will be. But it can make use of the information which is available to it; as it will do, if whenever possible it bases the assessment of the levy upon capital values as determined on the market. The market value of an asset is determined by what people expect to get from the asset as income in future years; no doubt this estimate is only partly based upon rational considerations, but it does take into account the more obvious information, available at the time, about probable future developments. This makes it a much more sensible basis for a levy than mere current income can be.

However, it is only for certain kinds of property (principally stocks and shares) that regular market valuations are likely to be available; for the rest, the services of valuation experts will have to be called upon, and the rather conventional values they are accustomed to put will have to be used. These may give no better result than would be got by capitalizing income. Even in the case of marketable securities, the significance of stock-exchange valuations depends very much upon the width and activity of the market. It is interesting to observe that in the British controversy about a capital levy after the last war it was taken for granted by nearly everyone that the levy would be confined to individual capital; there was implicit faith in the reliability of stock-exchange valuations of company prospects; the use of anything but stock-exchange valuations was only considered in the case of the owners of private firms or non-quoted securities. Since the ownership of the capital embodied in companies was thought to be adequately represented by the ownership of shares in those companies, the levy was to be entirely raised from the owners in their private capacities, the companies themselves not being involved at all in the collection.

When, on the other hand, we turn to the levies which have actually been imposed in other countries, we find without exception that the levies were laid upon business capital; indeed in many cases the greater part of the levy was collected, not from private individuals, but from firms. The main reason for this was no doubt sheer inability to assess individual capital at all completely, excepting when it took very tangible forms; countries without an efficient income-tax, and where a large proportion of shareholdings were in the form of bearer securities, felt that a levy on individual capital alone would fail to reach most of the capital it was desired to tax. But it is further clear that the stock-exchange valuation of corporate capital was regarded with considerable scepticism; all sorts of rather bizarre alternatives (averaging nominal capital with the capitalized value of current profits, and so on) will be found to be represented. For devices such as these an imperfect stock market seems hardly sufficient excuse; they make the standards of equity, which ought to be more characteristic of a capital levy than of a recurrent tax, dip very sadly over the horizon.

Still worse is the fact that in most of the central European levies after the last war both company and individual capital were taxed; thus in any case where information about individual holdings of securities did exist, those holdings would be submitted to the most flagrant double taxation. But in one case, that of Austria in 1920, a real attempt was made to prevent this double taxation by a system of offsetting; though this was spoiled in execution by the animus of Austrian politicians against big business, so that small shareholders in public companies were taxed at a higher rate than small shareholders in other businesses.[1]

Even if double taxation is avoided, it remains quite impossible to reconcile the collection of the levy from business capital with any reasonable system of progression in rates. A capital levy is usually expected to be progressive like any other direct tax, richer people being taxed by a higher proportion of their capital; this can only be done systematically if the levy is imposed on individuals and solely on individuals. There is, however, one thing to be said in favour of assessing business capital by valuing the assets of the business rather than by taking stock-exchange valuations—though it is on the whole a minor consideration when compared with those already mentioned. Private firms, which have no quoted securities,

[1] Cf. van Sickle, *Direct Taxation in Austria*, pp. 149–52.

have to be valued otherwise than by the market value of their securities; if holdings in some firms are valued in one way and holdings in other firms in another, systematic overtaxation of one group may easily arise. This sort of thing is most likely to occur on an important scale when prices are changing rapidly, or when conditions are otherwise disturbed. It is then very possible that stock-exchange valuations may be adjusted to new prospects, which would also affect the prices at which private firms would change hands; but these new prospects cannot be allowed for in any conventional valuation of the capital of private firms, for that is bound to look to the past or present rather than the future. In this way a good deal of inequality may arise.

The difficulties in the way of making a fair assessment when economic conditions are unsettled do, however, go much farther than this. The full assessment of a levy is bound to take a good deal of time; if values are changing rapidly, this is bound to mean that some properties will be overvalued relatively to others. It might be thought that this difficulty could be overcome in the case of quoted securities, since it can be laid down that their values should be taken as they stood in the market at a given date; yet this is even less equitable than it looks. In times of economic disturbance, the values of securities at a given date are bound to be related to one another in something other than a normal way; when we remember that the levy is going to affect people's incomes for a long time in the future, it becomes clear that the assessment of a levy when the relative values of securities are very abnormal will mean that some properties will be over- and some under-taxed. Taking all these things together, it would appear that there is a strong case on grounds of equity for imposing a levy, not when conditions are abnormal, but when they have returned to some degree of normality; although the levy is imposed to deal with an emergency, the time to impose the levy is when the emergency is passed, and fully passed. If the levy is imposed during war-time, the relative values of securities are bound to be extremely haphazard, future prospects being so utterly uncertain; if it is imposed soon after the end of a war, there will probably be some securities whose values are inflated by abnormal opportunities of profit, which will soon pass away; there will be others which have not yet adjusted themselves to a new level of prices. Almost all the arguments against the equity of a levy are diminished in force if the

levy is imposed in fairly normal conditions; if it is desired to deal with a war debt by means of a levy, it is much better to wait before imposing it until things have at least begun to settle down.

To this principle there is of course one obvious exception. If the levy under consideration is not a general levy but an Increment Levy—that is to say, a levy upon increases in capital wealth during the war—then it is essential to impose it as soon as possible after the end of hostilities; otherwise not only war gains will be taxed, but post-war gains as well. Yet even here the points we have been discussing have some relevance. If an increment levy is imposed soon after the end of a war, when capital values have not reached anything like a normal post-war position, there will be some forms of property whose values are only temporarily inflated, others whose values will after a time be found to have increased, though the increase has not declared itself yet. Once again, there will be overtaxation in the one direction, under-taxation in the other. An increment levy cannot therefore expect to attain a high degree of equity. Yet since it will probably be held that almost any war wealth is fair game for the tax-gatherer, one cannot expect that much attention will be paid to this point. In fact, the prospects of making much of a success out of an increment levy are not very good; but for other reasons.

Although many of the schemes for capital levies discussed or carried through after the last war started off from the idea of an increment levy, this aspect of the proposal always faded into the background fairly rapidly. Even if (as did happen in some cases)[1] an increment levy was in fact imposed, it was always imposed concurrently with a general levy, and was in fact a relatively minor part of the whole measure. The reasons for this were twofold. In the first place, an increment levy is more difficult to carry out than a general levy. It involves two assessments of capital, not one; one assessment as in the general levy, and one assessment of what the taxpayer's capital was at some earlier date (probably pre-war), so that the levy can be laid upon the difference between these assessments. Direct evidence about the position at this earlier date is unlikely to be forthcoming, so that it will be necessary to rely upon a very rough estimate.[2] Unless the levy is to be very arbitrary

[1] Czechoslovakia (1920), Italy (1920). See below, pp. 213, 235.

[2] Cf., however, the German experience after 1913. See above, pp. 136 ff.

indeed, the taxpayer will have to be given some opportunity of challenging such an estimate; but this opens up such possibilities of delay and obstruction as to make the levy a very inefficient tax.

The other even more important reason which has militated against extensive use of the increment levy is the relative rarity of the circumstances in which it could be used to make a really useful reduction in the war debt. In conditions of high inflation, it is true that there will be enormous nominal gains of capital; but these are precisely the conditions in which delays in collection are most dangerous, since they will enable the taxpayer to satisfy the demands made upon him by paying in terms of a money whose real value has been even further reduced since the date of assessment.[1] In a more orderly state of affairs (such as that of Britain in 1919–20), the increases in private property resulting from the war are unlikely to be sufficient to make an increment levy a very tempting operation. Real capital is diminished in war-time, not increased; as we have seen,[2] some part of the expanded war debt corresponds to real assets which have been destroyed or otherwise depreciated. Most of the taxable increase in property would be a rise in nominal value, not in real value; although there may be some case for taxing this rise in nominal value, on the ground that people whose property has risen in terms of money value have suffered less from the war than others have done, the amount of revenue which could reasonably have been raised from this source would not be sufficient to make much difference to the debt burden. So at least it was found in 1920.[3] After the present war, it is most unlikely that the case for an increment levy will be any stronger; in Britain it may be even weaker. Price-controls are more rigorous, excess profits taxation is more rigorous; most of the increase in wealth which might be liable to a levy will be a nominal increase in the value of fixed capital (assuming some degree of inflation); other increases in value will have been already collected in E.P.T. It is safe to prophesy that the fiscal case for an increment levy will be found to be very weak; it is unlikely to get very far as a practical issue unless it is tacked on to a general levy. If a general levy is imposed, there would be something to be said for graduating the contributions according to increases in wealth as well as according to total wealth; not so much on the ground of taxing the war profiteer, as on the ground of tempering the wind

[1] See below, p. 225. [2] See above, ch. iii. [3] See below, p. 255.

to those who have been relative losers by inflation. But this would be no more than a minor modification in the general levy; the general levy is the main question.

We have seen, in the course of this chapter, a good many reasons for criticizing the capital levy on grounds of equity; these criticisms have less weight if the levy is carried through in fairly normal times, but they have some weight even then. What is there to be said on the other side? There are important economic arguments in favour, which we shall proceed to examine in due course; yet it is certainly not because of these sophisticated arguments that the levy has won political support. Labour and Socialist opinion has supported the capital levy just because it is a levy on capital; although there is more than a little in this point of view which can only be reckoned as sheer prejudice, there is also some sound sense, which deserves recognition. The advantage which accrues from the possession of capital is not exhausted by the fact that the capital yields an income; as may be seen from the case of the miser, who clearly derives what he conceives to be a continuing advantage from the possession of his hoard, yet who completely escapes from income taxation on it so long as he refrains from drawing any interest. Even if the income from a piece of property is almost entirely taken away from its owner by heavy income taxation, he still retains definite advantages from his ownership. He is able to consume his capital in an emergency, and in certain cases he may retain some power of industrial control. Annual income taxation can only allow for these advantages by charging a higher rate upon unearned than upon earned income; though this is quite a sensible way of dealing with the matter, it does not impose a burden which at all exactly corresponds to the advantages, so that it may still be questioned whether they have been properly dealt with. If there were to be a fall in the rate of profit on capital to one-half of what it was previously, the income from a given capital would be reduced, and the income tax due to be paid on that income would be reduced correspondingly; yet the other advantages derived from the possession of that capital would not be reduced correspondingly, whence it appears that these other advantages cannot be fully allowed for in an income tax, however constructed. But though ideas of this sort have probably played their part in winning support for a levy on capital, it is not the single emergency levy to which they really point, but the recurrent

capital tax. The advantages derived from the possession of capital are continuing advantages; they cannot be dealt with by a single levy, unless it is completely expropriatory, and unless steps are taken for the prohibition of private fortunes from that time on. If any less drastic measures are taken, the problem will simply recur as new fortunes are built up. To impose a large capital levy at regular but infrequent intervals would be an absurd policy; the alternative of a regular capital tax of moderate dimensions has much more to be said for it.

A variant of this argument which has lately received some attention[1] would suggest that the imposition of a regular tax on capital during war-time is the only way of preventing wealthy people from 'evading' even the heaviest income taxation by living on their capital. It is of course quite true that heavy income taxation does not compel the man with capital to restrict his spending as the man without capital is compelled to do. One of the advantages of possessing capital is to have a reserve fund for emergencies; some people may regard the special taxation they have to pay in war-time as constituting such an emergency. If the capitalist lives beyond the income which is left to him after income taxation, he is diminishing his prospects of future income; yet he may prefer to do this rather than restrict his consumption in the present still further. It is very desirable to stop this sort of thing, yet it does not appear that a capital tax would do much to stop it. A person who retains a lively faith in a future after the war, a future worth making sacrifices for, will be extremely reluctant to eat into his capital very much; thus income taxation will cut down his expenditure almost correspondingly. A person whose faith in the future is weak will hardly restrict his expenditure so long as he has any capital left to live on. Between these extremes there are no doubt some persons whose expenditure would be cut down by the tax; but whether the extra resources put at the government's disposal (the extra reduction in consumption due to a capital tax above what could be secured by income taxation) would be worth the trouble of collection is very doubtful. The true place of the capital tax is not as an instrument of war finance, but as a part of the regular tax system. As we go on, we shall encounter other reasons in favour of its use in that capacity, if it should prove to be administratively practicable.

[1] Through the writings of Mr. Douglas Jay.

CHAPTER XXI

THE ECONOMIC CONSEQUENCES OF A LEVY

IF a belligerent country covers a large part of its war costs by borrowing, and then takes no steps to diminish the debt thus accumulated, it will have to face the prospect of large interest charges extending into the indefinite future, charges which will have to be met out of the budget, so that regular taxation will have to be imposed to cover them. Assuming for the present that the war debt is held internally, by the country's own citizens, then the raising of this taxation and the payment of the receipts in interest are nothing but a transfer from one group of citizens to another; it is even possible that the taxes may be raised from very much the same people as are due to receive the interest, so that the whole transaction becomes nothing else but a transfer from one to another of the taxpayer's own pockets. But even in this extreme case the proceeding is not a pure book-keeping transaction; it may still have important economic effects. The distribution of the interest payments among the recipients depends upon the distribution of debt holdings; it is more or less fixed up in advance. But if the taxation needed to cover these interest charges is raised by ordinary income taxation or the like, the amount of taxation payable by each particular taxpayer depends upon the current income which he is earning. The deleterious economic effects attributable to a large war debt are the deleterious effects of high rates of income taxation.

It is the consciousness of these effects which has often enlisted economic opinion in support of the idea of a levy. Though fully aware of the defects of a levy from the point of view of equity, economists have been won over to its support when they considered the alternative. Heavy income taxation, though it does not fall upon the margin of exertion and enterprise with the same concentration as excess profits taxes do, nevertheless does fall upon that margin; in ordinary times, when the profit motive is playing a larger part, in directing and in stimulating the activity of industry, than it is likely to do during war, this effect may be very serious. Recent developments of economic thought[1] make it

[1] Particularly those associated with Mr. Keynes's *General Theory of Employment* (1936).

necessary to lay even more stress upon this point now than was the case when the matter was discussed after the last war. When Professor Pigou wrote his important essay upon the Capital Levy[1] (in 1927) it was possible for him to maintain, after an apparently exhaustive inquiry, that the check to productive activity, due to high rates of income tax, had been much exaggerated. He made a careful examination of the factors affecting the supply of labour (or exertion), and concluded, with justice, that the supply of labour is probably inelastic, not much likely to be affected even by very high rates of income tax. It is now apparent that this does not exhaust the issue. The effect of high income taxation on the willingness of the business man to bear additional risks—its effect upon the margin of enterprise—is a much more serious matter than its effect upon the supply of labour.

Let us suppose that a firm is considering the installation of some new equipment, which will cost £10,000 to put in. It is in a position to borrow the capital which will be needed, but will have to pay 5 per cent. on the loan. Then no profit will be earned on the installation unless the net additional earnings (after allowing for depreciation) are more than £500 per annum. But the equipment will not necessarily be installed if the prospective earnings are greater than £500. There is always a chance that less than £500 will in fact be earned, in which case the investment will prove to have been a mistake and a source of loss. Consequently it will not in fact be worth while to undertake the installation, unless there is sufficient prospect of gain (by the achievement of net earnings above £500 per annum) to outweigh the risk of loss (by earning less). It may be that a probable return of £600 per annum (leaving £100 after paying interest on the loan) would be considered to be sufficient to offset the risk. At any rate there will be some such figure which will do so. But since earnings above £500 will be liable to income tax, this margin has to be calculated after income tax has been allowed for. If the rate of income tax is 5*s.* in the £, the actual prospective yield has to be £633 before it will be worth while to make the investment. If the rate of income tax is 10*s.* in the £ the necessary yield rises to £700. Now there will be many kinds of business which will offer a prospect of something corresponding to the lower figure, but which could not be under-

[1] Pigou, *Public Finance*, the concluding chapter. Cf. also Report of Colwyn Committee, pp. 164–9.

taken if the higher figure had to be covered. (It should be observed that the necessary yield rises more than proportionately to a rise in the rate of tax.) High rates of income tax do have a very deterrent effect upon enterprise, and consequently a very depressing effect upon industry generally.[1]

This depressing effect of high income taxation occurs just because the tax varies with income—because anything which is done to secure a higher income carries with it the liability to a greater amount of tax. The case for the capital levy on the ground of economic effects is therefore precisely the same as the case against it on the ground of equity—that once the levy has been collected, the burden on each taxpayer is fixed, and cannot be affected by what he does (or by what happens to him) subsequently. The more favourable economic effects are secured just because of the less equitable adjustment.

This is the case for the capital levy as it presents itself to economists; whether it is regarded as a sufficient case will of course depend very much upon circumstances. During the discussions which took place in England during the early years after the last war, the weight of opinion gradually turned against the levy, mainly on the ground that a levy on the scale proposed would not permit of a sufficient reduction in direct taxation for it to be worth the trouble involved. In Great Britain interest on war loan is subject to income tax, and holdings of war loan are subject to death duties; consequently the cancellation of a large part of the national debt would reduce the receipts from ordinary taxation fairly heavily, and the net gain to the Exchequer from the imposition of the levy might be surprisingly small.[2] On another occasion it is very possible that these considerations might have even greater force. If the question of imposing a capital levy comes to be considered in England after the end of the present war, income tax and death duties will certainly be higher than they were in the twenties, interest rates will very probably be lower; each of these changes will make the net advantage to the revenue of imposing a progressive levy even less than it was fifteen years ago. But it is still likely that there will be some net advantage; the loss in receipts from other taxes may approach the saving in interest very nearly

[1] The full implications of this will be readily appreciated by readers of Mr. Keynes's *General Theory*.

[2] See below, ch. xxix, for a full discussion of this point.

but will not exceed it. High rates of income tax and surtax mean that a large proportion of the sums paid out in interest by the government come back to the government in income taxation; high rates of death duty mean that a large proportion of the principal of the debt will come back to the government sooner or later; but even when these things are allowed for, there will be some net outpayments by the Treasury, dwindling indeed as time goes on but nevertheless considerable in total, which could be avoided if the debt were cancelled by a levy straight away. If rates of income tax are very high, the gain from a capital levy is small; but since the check to enterprise from high rates of income tax rises so steeply as the rate goes higher, even a small reduction from such high rates may be well worth having. Consequently the question may still remain open. Before we can reach even a provisional conclusion about the desirability of a levy on economic grounds, we must examine the economic consequences of the levy more thoroughly. We have seen that a large debt, unreduced by a levy, would be likely to have a depressing effect upon business activity. What would be the effect of the levy itself?

The question whether the levy itself will have a stimulating or a depressing influence on business—whether its effects will be inflationary or deflationary—is not one to which a simple answer can be given. It all depends on the circumstances in which the levy is imposed, and on the way the proceeds are used. We must also distinguish between immediate effects, and effects in the long run. This gives us quite a number of separate questions to consider.

The first distinction which is relevant to the immediate effects of a levy is that between a levy used to repay debt and one used for the financing of current expenditure (usually military expenditure). A capital levy used to finance war expenditure is definitely inflationary; it can be very inflationary. Since the principal economic function of taxation in war-time is the reduction of private spending, a capital levy gets very poor marks as a war tax. Only a small part of what taxpayers would have to pay could be met by a reduction of their current consumption; most of it would have to be met either by selling off assets or by borrowing. It is not likely that many of the assets sold off would be such as were directly required by the State for its own purposes; most of them would be in the form of securities, which are of no use to the State directly,

and which can only be sold off if someone is prepared to buy them. The buyer can only buy out of new savings (which would probably have been lent to the State if there had been no levy) or out of an expansion of credit. The same holds if the levy is met by borrowing in the first instance. Thus for the most part, the funds provided by a capital levy do not come out of a reduction of private spending; they are secured either by an expansion of credit, or by absorbing some of the savings which would otherwise have been borrowed directly by the State. To finance a war by a levy on capital is very nearly as inflationary as to finance it by direct borrowing; the principal difference is that the capital levy makes the taxpayer shoulder the obligations resulting from the borrowing, instead of the State doing it for him. This is indeed an advantage from the State's point of view; but it is not the same sort of advantage as is got from a tax which transfers current income to the disposal of the State. The revenue authorities may go to all the trouble involved in the assessment and collection of a capital levy, yet in spite of this they will have made no corresponding progress with the collection of revenue in the sense which is economically important. It will be almost as necessary to impose other taxation as it was before the levy was imposed; the fact that a capital levy produces revenue which looks like ordinary tax revenue, yet is not so good as ordinary tax revenue, makes it very dangerous as an instrument of war finance. It is even conceivable that a budget might be produced which was apparently balanced, all the expenditure being covered out of taxation, and that nevertheless this budget might be extremely inflationary, if the taxes fell on capital and could only be paid out of an expansion of credit.

This analysis seems to be completely confirmed by the experience of those countries which have recently used capital levies as a means of financing rearmament and pre-belligerency. Neither the Italian nor the Hungarian levy[1] was on a large scale; those persons liable who were given the option of spreading their contributions over three or four years would find it amounting to no more than a fairly heavy income tax. But it is significant that many taxpayers had to be given such an option—which amounts to the same thing as the State advancing them the money to pay the levy, at least for a limited period. And in order to collect any revenue out of those

[1] See below, ch. xxvi. The German levy of 1913 (see above, p. 136) was on too small a scale to have any of the economic consequences of a levy.

who had to pay up at once it was necessary in each case to facilitate borrowing—either by the taxpayer himself or by third parties who might take over property disposed of by the taxpayer. The same credit expansion as would have resulted from direct government borrowing took place in an indirect way.

The sole advantage got by the State from a capital levy of the Italian type is the substitution of private indebtedness for State indebtedness; although there is something to be said for this in the long run, a period of intense rearmament is not one in which the depressing effect of income taxation need cause much concern. The Hungarian levy had more to be said for it. It was imposed when there was a setback in trade; the rearmament had the economic object of acting as a form of public works to counteract the recession, as well as its political object. The use of a capital levy to secure the advantages (as they may be in this case) of an unbalanced budget, without appearing to unbalance your budget, is rather a good idea. But it has nothing to do with questions of war finance. A capital levy in war-time has most of the bad effects of borrowing and is a great deal more trouble. There is really nothing to be said for it at all.

The economic effects of a post-war levy, used to redeem war debt, are very decidedly different. In this case the proceeds of the levy are not treated as revenue; the whole transaction takes pace on capital account. Consequently it does not matter if there is an expansion of credit to facilitate payment of the levy, since this expansion will be offset by a contraction, due to repayment of the debt. Subject to an important exception, which we shall notice presently, the main danger of a capital levy of this kind is not that it may be inflationary, but that it may be deflationary. The amount of deflation caused will certainly be much smaller than the amount of inflation caused by a war-time levy treated as revenue, but that does not mean that it will be negligible. A moderate amount of deflation is often more dangerous than a moderate amount of inflation.

Let us begin with the case which would cause the minimum of trouble, that in which the scale of the levy is moderate, and the war debt to be cancelled is distributed among property owners in such a way as to make it possible for each taxpayer to meet his obligations by disposing of a part of his holdings of war loan. If this were done, no expansion of credit (or at the most a very

transitory expansion) would be necessary to enable the levy to be paid; either the levy would be paid directly in the form of war loan, or if the taxpayer preferred to sell off his war loan and pay in cash, the government would step in to purchase the war loan and provide the cash, which would immediately return whence it came in payment of the levy. But even in this case there is a question whether the taxpayers would in fact prefer to meet their obligations in this way. Government Stock is not quite like other assets; it is a rather specially liquid asset, particularly suitable for holding as a reserve against emergencies and particularly acceptable as collateral for loans; thus even if it were possible for all taxpayers to meet their obligations by selling war loan, it is very likely that some of them would prefer to sell off other forms of property instead. The situation would then be that the government would be buying back war loan to a certain amount, while other assets of a more or less equal value (perhaps in the main other securities) would be placed on the market. This must lead to a fall in the values of these other securities relatively to those of government securities: that is to say, a rise in the rate of interest which is relevant to industrial borrowing, relatively to the rate on gilt-edged. This widening of the gap between different sorts of interest rates would be nothing to worry about provided it took the form of a fall in the gilt-edged rate, that on industrials remaining steady; but if it took the form of a rise in the rate of interest on industrials, the effect on business activity would be more serious. Thus even in the case we have been considering, when the levy *could* be paid out of the taxpayers' holdings of government stock, there would be something to be said for taking special measures to facilitate financing, in order to ensure that the disposal of assets, which were unsuitable for acquisition by the government, did not have too depressing an effect on industry. In practice, when it is unlikely that this convenient assumption would be justified, the case for such measures would be much stronger.

If the scale of the levy were more considerable than we have been supposing, and if holdings of war loan were not distributed in this convenient way, it would be absolutely necessary for a good many of those persons who were liable to the levy either to dispose of a miscellaneous collection of different sorts of property in order to get the funds with which to meet their obligations or alternatively to borrow. It might appear at first sight as if sufficient funds

to purchase this property, or to satisfy this demand for credit, would be forthcoming from the repayment of the government debt; but it is in fact fairly certain that not all the funds released by the repayment of the debt would be used in this way. A person who sold Government Stock, and used the proceeds to purchase material property, or some more speculative security, would find himself in a less liquid position than he was before; he would be less able to stand up to possible future losses or difficulties than he was before. Thus it seems fairly certain that there would be at least some people who would be unwilling to make an exchange of this sort without fortifying their positions in some way; either they would keep a part of the proceeds of their sales of Government Stock by them in the form of larger bank deposits, or they would use it to reduce debts (overdrafts and so on). If this happened, it would mean that the property which had to be sold to meet the levy could not be disposed of without some appreciable concession in price. At the least, there would be a fall in the industrial section of the stock exchange; and wider deflationary effects would be likely to follow, through a restriction of business borrowing for productive purposes.

Effects of this sort are likely to be particularly severe in countries which do not possess a well-developed financial system, since better organization of financial markets makes it easier for people to adjust their holdings of different sorts of assets to the types of risk which they are willing to bear. In the absence of well-organized markets, the property which has to be disposed of in order to meet a capital levy may be almost unsaleable. When a capital levy has been imposed in such a country, it has generally been necessary to set up special institutions, financed by the State, to acquire the property in question, disposing of it gradually as opportunity offers. But for these institutions to have to take over a lot of physical property which is not in the form of stocks and shares is certainly a most undesirable thing; such property is most unlikely to be used very intensively or very economically when it is more or less in the hands of a public receiver. A much more sensible procedure is to stop the liquidation of such property by making liberal advances to the taxpayers enabling them to meet their obligations by borrowing (once again it would no doubt be necessary for the State itself to finance these loans); or, what comes to the same thing, the taxpayers may be permitted to pay the levy

in instalments over a long period. All these are just different ways of bringing about that expansion of credit which is necessary in order to enable the levy to be collected without undue dislocation.

In one or other of these ways the deflationary effect of a levy to repay debt can be considerably mitigated; but since the natural effect of such a levy is for it to be deflationary, there would seem at first sight to be strong reasons for trying to make use of these deflationary tendencies, choosing as the time of imposition a time when the economic system is suffering from the opposite danger, the danger of inflation. Attempts were actually made in several of the central European countries after the last war[1] to use the capital levy as an anti-inflationary measure, sometimes with the rather simple-minded idea of using the proceeds for direct cancellation of a part of the note issue, sometimes in order to have an alternative to the difficult process of funding the short-term debt. It cannot be said that these experiments offer very encouraging precedents, though the main cause of trouble was one which need not be repeated on another occasion. It often happened that the mere announcement that a levy was going to be imposed led to a large withdrawal of capital from the country; this induced a sharp fall in the (already weak) exchanges, and that led to a rise in internal prices, which the government was powerless to prevent. Thus, though the levy was meant to be deflationary, and would have been deflationary so far as its internal effects alone were concerned, in fact these internal effects were swamped by the flight of capital. The intended deflationary measure proved to be an inflationary measure after all. Then again, just because of the renewed inflation, and of the failure of the government to bring the financial situation under control, the proceeds of the levy could not be used for the redemption of debt but had to be applied to the financing of current expenditure. In this way even the internal deflationary effects were lost. The Austrian levy of 1920 is the clearest instance of this course to disaster.

There is, on the other hand, one instance, that of Czechoslovakia, in which these perils were almost completely avoided. The Czechs took the most drastic measures to prevent capital flight; financial relations with other countries were suspended almost completely for a fortnight (March 1919) during which the first preliminaries of assessment were made; if the Czech levy was

[1] Czechoslovakia, Austria, Hungary, Poland.

rough, it was certainly resolute. It is now probable that similar, though less extraordinary measures would be common practice on any future occasion. Exchange control is now universal in Europe; and though it is to be hoped that there will be a return to a rather more liberal régime at some time or other, that is not likely to happen at all speedily after the end of the present war. Excepting in countries with particularly weak governments, evasion by capital flight is not likely to be an important feature of future levies.

There is, however, another difficulty in the way of carrying through a levy in conditions of actual or potential inflation, which is not automatically overcome by the change which has taken place in monetary institutions. The central European levies were largely evaded, not only by capital flight, but also by unconscionable delays in payment; payment was often postponed so long that the original assessment was reduced, by the progressive inflation, to a fraction of its original value in real terms. Although the extreme forms of this abuse are characteristic of very badly managed fiscal systems, it is always likely to be a real danger when a capital levy is imposed in a time of rising prices. Of course, even when prices are stable, it is to the advantage of the taxpayer to postpone his obligation as long as he can; by postponement he secures the interest on the sum due, and this interest will probably be a considerable sum, an appreciable fraction (perhaps) of a normal income-tax liability. If a capital levy is to be carried through efficiently, strong measures need to be taken to ensure prompt payment; the gain of interest could be offset, for example, by a system of fines on arrears. Some such system is necessary in any case; but if prices are rising rapidly, fines which are ordinarily sufficient to offset the interest which would accrue to the taxpayer through postponement would not be sufficient to prevent evasion of this type. In conditions of inflation, the retention of an asset for a longer period offers not only the prospect of securing the normal interest for that period, but also the prospect of an appreciation in the value of the asset. If postponement is likely to result in rich gains of this sort, it will be particularly hard to prevent.

Examination of the economic effects of a levy thus seems to confirm the conclusion which we reached in the last chapter: if it is desired to pay off debt by a capital levy, it is much better to do so when prices are stable and conditions are fairly normal. It is true that when a levy is carried through in such conditions, its monetary

effects are likely to be deflationary. But this deflationary effect can be moderated in various ways, and it then presents far fewer dangers than those which beset so awkward an operation, if it is undertaken at a time when the monetary situation is not fully under control.

We may now turn to the long-run effects of the levy. Here it is important to notice that we have to consider not two, but at least three, alternatives. In the first place, the debt may be left unrepaid, only the annual interest being provided out of the budget. In the second place, the debt may be reduced year by year through a Sinking Fund. In the third place, the debt may be reduced at one blow by a levy, the remainder being either left unrepaid or still further reduced by an annual sinking fund. Assuming that the initial disturbance of the levy has been got over, what are the consequences of these various alternatives?

The trouble with the first course of action—that of leaving the debt unrepaid—is that it may involve very high rates of income taxation and these may have a depressing effect on enterprise. Apart from this effect on enterprise, which we have already noted, a do-nothing policy seems at first sight to be fairly neutral in its effects on economic activity.[1]

The second policy, that of gradual repayment, is definitely more depressing than the first. Still higher rates of taxation are necessary, if both interest and sinking fund are to be covered; thus the incentive to business expansion (and business borrowing) is diminished, while at the same time the government is putting additional funds, raised out of current income, into the hands of those whose holdings of debt are being repaid. This has exactly the same effect on the whole economy as if these funds had been saved voluntarily; spending power is transferred from the markets for goods to the market for securities, while there is no increased business borrowing to release this spending power at the other end. It is now generally realized that when saving cannot find an outlet, it tends to diminish business activity and to lower prices.

[1] The transference of income from more enterprising to less enterprising people (and perhaps from those who are less inclined to save to those who are more inclined), which is often considered to be a defect of this first policy, is actually a consequence of any method of dealing with the debt short of repudiation. If there is anything in the point, it has to be attributed to the mere fact of having acquired the debt, not to any particular method of dealing with it.

Unless there is some prospect of actually getting the debt paid off completely within a reasonable time, the policy of gradual repayment has little to be said for it. It is a continual drag upon business activity, and is unlikely to make much impression upon the load it is eating into so painfully.

These are the policies which have to be set against the policy of a levy. In order to simplify the comparison, let us begin by setting the sinking-fund complication on one side. Let us compare a pure do-nothing policy with that of a levy which is followed by no further attempt at repayment. In this case, once the levy was over, the interest due to be paid would be reduced, and taxation could be somewhat reduced—though it would appear that with the British tax-system the loss of revenue following on the levy might be such as to make the possible reduction in taxation rather small.[1] So far as it went, this effect of the levy would be favourable to enterprise; though from the point of view of industrial activity there has to be set against it a possible tendency for people to save more in order to rid themselves of the private debts which would probably be left by the levy. Nevertheless, an increase in saving which is accompanied by a stimulus to industrial investment is a very different matter from an increase in saving not so accompanied. The latter only leads to depression; but the former makes for real capital accumulation and steady progress.

This is little more than the tentative conclusion, favourable to the levy on the score of its long-run effects, which we had previously reached; it must now be noticed that in certain cases, and particularly in the British case, there are further complications, which may make a good deal of difference. British public finance does ordinarily operate a sort of small capital levy, in the form of death duties; these are raised from capital, but applied to current expenditure. Consequently it is not strictly true to say, as we began by saying, that a do-nothing policy is neutral with respect to economic activity. The State is in the habit of absorbing current savings to a fairly considerable amount in the finance of death duties; this is quite sufficient to make a difference to the balance of the market. It is of course only necessary to take this sort of point into account in an argument like the present if it is relevant to the

[1] For detailed discussion see below, ch xxix. It is this comparison—between a no-repayment policy and a levy followed by a no-repayment policy—to which Stamp's celebrated calculation directly applies.

effects of a capital levy proper; but as a matter of fact it is relevant.

One of the consequences of imposing a large levy would be a considerable loss in receipts from death duties; this is one of the main causes why the net gain to the revenue is so much smaller than the direct saving in interest. But if the amount of death duties received was diminished, this would mean that the amount of current savings absorbed by the government and devoted to current expenditure was diminished too. There is here an extra source of excess savings, probably sufficient to make it necessary for us to revise our provisional conclusion. With British fiscal practice it is not at all certain that the long-run effects of the levy, as well as the immediate effects, would not be depressing—provided we assume that no attempt is made to reduce the debt otherwise than by the single levy.

We can check over this conclusion, and perhaps make it appear more evident, if we make a parallel analysis of the effect of a levy in the case when a sinking fund is taken for granted. There is one highly respectable state of affairs (perhaps it may be regarded as the ideal of traditional fiscal practice, though if so it is an ideal rarely reached) where, although death duties are used for current expenditure, a sinking fund is paid out of current revenue, and the two amounts nearly balance. In this situation, the economic activities of the State would be genuinely neutral in their effects on the state of trade. The savings absorbed by the death duties would be released by the sinking fund; the State would neither help nor hinder. Now if a levy were imposed in this situation, and it was desired to maintain the same economic neutrality after the levy as before, the sinking fund would have to be reduced *pari passu* with the fall in receipts from death duties. If this were not done, the same deflationary effect would arise from the imposition of the levy as if there were no sinking fund to reduce.

Fortunately, other reasons would doubtless concur to suggest that a smaller debt could do with a smaller sinking fund. To maintain the same sinking fund would mean paying off the smaller debt more rapidly than the larger debt was to be paid off; such a policy would have little to recommend it to anybody. Thus, if it has once been decided to pay off the debt by an annual sinking fund,[1] there is a very good case for doing the job more quickly by

[1] When the matter is approached from this angle, it becomes evident that the saving in sinking fund ought to be included in the total saving from the

a levy; but if the country is satisfied with a do-nothing policy, or a policy of small sinking funds, much smaller than the amount raised in death duties, then the case for imposing a levy must be judged to be seriously weakened.[1]

levy—or alternatively the loss in death duties ought not to be deducted. If this correction can be made, the net gain to the revenue from imposing a levy becomes much more considerable.

[1] It should be understood that a no-repayment policy does not exclude the use of nominal sinking funds as a convenient method of budget accounting. At some stages in the trade cycle government borrowing is desirable, at others it may be desirable to repay debt; these adjustments may be made with greater political convenience if a nominal sinking fund is retained, but a deficit which is no larger than the sinking fund is regarded as a peccadillo

CHAPTER XXII

THE CAPITAL TAX

THERE is one further possible means of debt reduction which remains to be considered. It has sometimes been suggested[1] that a fairly innocuous method might be found in the imposition of an annual tax on capital, presumably of moderate dimensions, whose proceeds would be used for gradual repayment—that is to say, a small capital levy repeated every year for a number of years. There is, as we have seen, quite a good case for such a tax on grounds of equity; can it be brought to the rescue here? One would like to think so, but in fact the answer seems to be much the same as with the single levy. If it has once been decided to redeem the debt, it may be better to do it out of a capital tax than out of ordinary income taxation; but if the alternative is to leave the debt unredeemed, then there is not much to be said for redeeming the debt out of a capital tax.

Gradual repayment of debt is always likely to be a depressing influence. It can only be prevented from being depressing if the funds used for the repayment are provided in some other way than by being withdrawn from current spending. A capital tax, being assessed on capital, might be thought to secure such funds, but that is not so. The important thing is, not how the tax is assessed, but how it is paid; there can be no doubt that if the tax is moderate in amount (the rate of repayment is no larger than could have been achieved out of the ordinary budget) it will be paid out of income. It will be possible to meet a good part of the tax by reducing consumption, and the ordinary prudential principle of maintaining capital intact will dictate that this should be done as far as possible. So far as its effect on current spending is concerned, there will be no appreciable difference between a capital tax and an income tax of equivalent amount.

It is true that if the capital tax were to be larger than this, it would cease to be possible for the whole tax to be paid out of income; consequently it might be possible to secure a more rapid rate of repayment by using a capital tax than by ordinary sinking-fund methods. But although this more rapid rate of repayment

[1] Rather obliquely by Mr. Keynes, *How to pay for the War*, p 48.

would be secured without private spending being reduced much farther, it would be reduced somewhat farther. The depressing effects would be rather greater than with an ordinary sinking fund, and it would take much longer than with a capital levy for the principal of the debt to be reduced far enough to lighten the interest burden appreciably. If this were the alternative, it would be better to have a single levy.

It is much more probable that the capital tax might have something to contribute to the war-debt problem if it were used as a means of raising revenue to meet the interest charges than if used as a source of funds for gradual repayment. Since the tax would largely be paid out of income, there could be no objection to using it as a source of current revenue, any more than there is against using the British local rates as a source of current revenue. Where it might have a considerable advantage over an income tax is in its effects on business incentive. It is very possible that a capital tax might have a less discouraging effect on enterprise than an income tax with an equivalent yield; though the extent to which this happened would depend upon the way in which the tax was assessed.

It is necessary, first of all, to clear out of the way one administratively tempting method of assessment which would not do at all from the economic point of view. Perhaps the commonest sort of capital tax in actual experience is a tax which is assessed separately on certain particular sorts of property—land, houses, and so on. This sort of tax has obvious conveniences from the side of assessment and collection; it is not impossible that it could be extended to cover other sorts of property than the fixed capital assets to which it has usually been confined. When it came to business capital (whether that is regarded as consisting of stocks and shares, or as consisting of the plant and materials to the joint ownership of which the stocks and shares are titles), convenience of collection would obviously dictate that the tax should be collected at the source, from the firms and not from the individual shareholders. But this would ruin the tax. Income tax on profits can be collected at the source, because if there are no profits there will be no tax. But in a particular year there might be no profits, and yet the capital value of the concern might not fall to nil, so that there would still be some capital tax to be paid. Unless the firm had some means of recovering the tax from its shareholders—which does not look feasible—the tax would be a direct addition to over-

head costs, and would have to meet the same objections as have been made against the levying of local rates on industrial property.[1] Such a tax might be a worse burden upon business than an income tax; it would certainly fail to show any superiority.

The only sort of capital tax which can establish a good case for itself on economic grounds is one which would be modelled on the better sort of capital levy. It would have to be laid on individual holdings of capital, and collected from individual capitalists, just as a capital levy ought to be imposed and collected. This would be a considerable problem administratively, perhaps even more serious a problem than a single levy. Equity would demand that the valuations on which the tax was based should be kept well up to date, and repeated valuations would be expensive. But assuming that these difficulties could be overcome in a satisfactory manner, there would be real economic advantages to set against them, advantages which are worth serious attention.

As in the case of the levy, it is necessary to distinguish between the case of the public company and that of the private firm. The public company, whose shares are quoted on the stock exchange, would not be involved in the tax in any direct way. There would be nothing analogous to the levying of income tax upon undistributed profits, since capital gains made by companies could be taken to be adequately reflected in the market value of their shares. The shareholders would pay a tax based upon the market value of the securities in their possession; the company, as such, would not pay any tax at all. It seems unlikely that the decisions of company directors and managers would often be affected to any appreciable extent by calculations of the effects these decisions would have upon the amount of taxation payable, not by the firm itself, but by its shareholders. The capital tax would come into their calculations much less directly than the income tax does.

Even if the capital tax were to be taken into account, its effect should be distinctly less discouraging to enterprise than the effect of an equivalent income tax. In order to see this, let us go back to the numerical example we used in the last chapter.[2] A firm is installing new equipment, costing £10,000. It borrows the money at 5 per cent., and is content to do so, because it expects to make an extra £600 per annum, after allowing for other charges. If its

[1] And which led in Britain to the Derating of 1929.
[2] See above, p. 192.

expectations prove to be justified, and profits do run at the rate hoped for, the capital value of the concern (and therefore the market value of its shares) will probably be raised.[1] But it will not be raised in proportion to the extra £100 of net profits, because there are extra fixed liabilities to be met before an ordinary dividend can be declared, and this increases the uncertainty of attaining a particular level of dividends.[2] A capital tax, based upon the market value of shares, will therefore fall upon the margin of enterprise with less force than an income tax will do. There will, in any case, be a diminished deterrent to corporate enterprise, and this is a distinct point in favour of the capital tax.

Things might possibly be different with the private firm, whose shares are not quoted on the market; a different method of assessment would have to be employed here in any case. Of the various devices which have been suggested and used for applying the capital levy to the case of the private firm, the commonest, valuation of holdings in private businesses by capitalizing income, would be fatal to the principle of the capital tax; the capital tax would be converted into a mere variation of income tax, with the same economic disadvantages as a high income tax. There is, however, an alternative. It would be possible to assess the capital of the firm on the same basis as that employed in Great Britain for the purposes of excess profits taxation. The valuation would be taken on the assets side, each physical asset being reckoned (according to the accounting principle) at cost or market value, whichever is the lower. So long as this principle was followed, no increase in capital value would be registered as a result of successful improvements, unless the profits earned were put back into the business, or unless the business (or that part of the business incorporating the improvement) were to be sold off. Since there would always be some chance of this happening, there would be some check to enterprise as a result of this part of the capital tax, but it would be relatively slight, just as the check to corporate enterprise would be relatively slight. The restrictive effect, which would follow from

[1] The 'internal' value of the concern (the capital value as estimated by the directors) must be raised, if there is to be an incentive to overcome the initial risks of installation and reorganization.

[2] The most probable amount of annual net profits is raised by £100, but the chance of falling below that amount by a certain percentage is greater than the chance of falling below the old most probable amount of profits by the same percentage.

an income tax yielding the same revenue, would be largely avoided in a capital tax of this sort.

This is the kind of capital tax to which we seem to be led by economic considerations. It should be a personal tax, not a tax on businesses; capital must not be valued by capitalizing income; the tax should not be used for repayment of debt, but as a source of ordinary revenue.[1]

[1] The German *Vermögenssteuer* (which was introduced in Prussia during the eighteen-nineties, and taken over by the Reich in 1922) does appear to be a general capital tax, at least in principle. Nevertheless, it is not a very satisfactory tax on economic standards. It is levied both upon individuals and upon businesses, thus involving itself in double taxation; and it makes far too much use of the method of capitalizing income. It would be interesting to know how successful it is in overcoming other valuation difficulties; it should, however, be remembered that it dates from a time when German standards of fiscal efficiency and equity were not particularly high.

PART VI
THE CAPITAL LEVY IN PRACTICE

CHAPTER XXIII

THE CENTRAL EUROPEAN LEVIES (1919–24)

CAPITAL levies have been imposed in practice; but their history is not on the whole a very encouraging one. There has been no example up to the present of the big successful levy which would really make a substantial contribution towards the cost of war. There have been big levies, or levies which were intended to be big; we shall discuss the most important cases in this and in the following chapters.[1] At the very best, as in Czechoslovakia, they were only moderate successes; usually they were utter failures. The quite successful rearmament levies of Italy and Hungary were on a small scale; they were not much more than special emergency taxes on property. Taken all together, these cases do not prove anything about the feasibility of a levy under appropriate conditions; but they do reveal something of the difficulties which may arise. That is why they are worth studying.

Some of the most interesting of the levies are those which were carried out in the Successor States of the Dual Monarchy.

Czechoslovakia, Austria, and Hungary started out with similar fiscal and administrative traditions. At the close of the war they were faced with very similar problems. In all three States there was almost complete industrial, agricultural, and financial chaos. Stocks of raw materials of all kinds were depleted, repairs and even safety measures had been neglected. In agriculture there was a chronic shortage of fertilizers, and live stock was reduced to a third of the pre-war level. The financial outlook was even more confused. The Dual Monarchy had financed the war by borrowing and by unfettered recourse to the printing press. The armistice

[1] In addition to the post-war levies which we are about to describe, levies were imposed in Poland and Greece. They were rendered abortive by inflation in much the same way as in Austria and Hungary. In France, and also in Switzerland, there was a good deal of discussion about the possibility of a levy; but nothing came of it in either case.

found the three States flooded with an enormous number of practically worthless bank-notes.

In all three States again, civil disorders interfered with reconstruction. In Hungary there were two revolutions in quick succession, that of Count Karolyi in October 1918, and the Communist revolution of Bela Kun from March to August 1919. In Czechoslovakia there was also Communist trouble, while Austria was torn both by class strife and by the quarrels of pro-German and pro-Austrian elements. In all three States, further, the process of reduction of public expenditure was much impeded by the high cost of administration. During the war the civil service had been enormously increased. In addition, after the armistice civil servants returned to their own States from ceded territories. In Czechoslovakia their ranks were further swelled by the necessity of expanding the proportion of reliable Czechs employed. The increases in the salaries of civil servants as prices rose was an important aggravation of post-war inflation, and was a trouble with which the governments were too weak to deal effectively. In Austria and Hungary the difficulty was ultimately eliminated only with the League reconstruction. Finally, besides the urgent need of continuing food subsidies and other extraordinary expenditure during the period of transition, there was, particularly in Czechoslovakia and Hungary, a pressing need for land reform. The break-up of the large estates was a necessity both on politico-economic and on nationalistic grounds.

The primary purpose of the levies in all three States was the reduction of the bank-note issue and of other State debts. In Czechoslovakia and Hungary there was also an important element of land reform. In spite of all these similarities, however, the results of the three levies were very different, and it is largely this fact that makes their experience of interest to other countries, in spite of the—fortunately—exceptional conditions under which they were imposed.

In Czechoslovakia, where psychological and material factors were relatively favourable, the work of financial reconstruction started almost immediately after the armistice. At the beginning of 1919 three successive measures were imposed. First, all bank-notes in circulation—i.e. notes of the Austro-Hungarian Bank—were stamped and a proportion were cancelled; secondly, property

was registered and partially blocked; thirdly, a capital levy was announced, coupled with a tax on war wealth.

The stamping of the bank-notes was carried through between 25 February and 9 March 1919. Fifty per cent. of the notes presented were withheld as a compulsory loan bearing interest at 1 per cent. On technical grounds small notes (1 and 2 Kronen) were exempt, thus only the 10, 20, 50, 100, and 1,000 Kronen notes were stamped, Sums of less than 300 Kronen were exempted from the compulsory loan. As it was intended to use this loan as security for the capital levy, it was declared to be non-mortgageable and non-transferable *inter vivos*. As a further step current accounts at branch offices of the Austro-Hungarian Bank on Czechoslovak territory, and Treasury bills issued by these branches were—as regards 50 per cent. of their value—also converted into a forced loan of the same type, also bearing 1 per cent. interest.[1]

The second step was the registration and blocking of all kinds of property. The amount of bank-notes withdrawn formed a reliable guide to the number of bank-notes in the possession of each individual on 1 March 1919. At the same time the recording of deposits was carried out by the banks, under the penalty that deposits not notified would be forfeited to the State. This was necessary in order to ascertain the real owners of the deposits, which were frequently entered in the deposit books of the banks under assumed names. At the same time an embargo was placed on 50 per cent. of the deposits, partly to save the credit system from difficulties owing to withdrawals after stamping, partly to

[1] The total debt of the Austro-Hungarian Bank, which was thus taken over by the Czech State, amounted to 10·1 milliards Czech Kronen. This was the aggregate of the Kc. 8 milliards bank-notes, held and in circulation on Czech territory at the time of stamping, of the Kc. 1·6 milliards in current accounts and Kc. 0 5 milliards of Treasury bills issued by the branch offices of the former Austro-Hungarian Bank on Czech territory. From the Kc 8 milliards bank-notes only 2 8 milliards were withdrawn by the stamping operation, thus the 50 per cent. principle—owing to the non-stamping of small notes and exemption of small amounts presented for stamping—meant in fact only a 29 per cent. reduction of the bank-notes in circulation. Of the stamped bank-notes, those held by the public were later exchanged for State notes of the Czech State, a purely technical procedure without fiscal or economic consequence. In exchange for the notes withheld the public were given deposit certificates which were later returned to the Treasury in payment of the levy. Corresponding amounts of bank-notes were then simply annihilated. Up to the end of 1925, of deposit certificates amounting to Kc. 2·8 milliards, only 0·38 milliards were still held by the public. The rest had been paid in on account of the levy.

serve as guarantee for the property tax. This embargo was subsequently reduced to 20 per cent. when the danger of withdrawals had disappeared. The recording of securities was also carried out, and bonds, shares, and dividend warrants were stamped. Further, all claims had to be registered, again with the penalty that those not notified should be forfeited to the State. Registration was ultimately extended to stocks of goods, real estate, industrial equipment, mortgage claims, and life insurance policies.

These preparations were completed by the end of August 1919, when the records were collated for the purpose of drafting the capital levy bill. The law was passed in the Czech National Assembly on 8 April 1920. The Act of April 1920 was the basic law of the levy. Subsequent legislation (21 December 1923 and 15 September 1924), although modifying the conditions of payment, did not alter the structure and terms of the levy.

In practice, so far as individuals were concerned, two combined levies were imposed simultaneously: a capital levy on total property and an increment tax on war wealth. Corporations did not pay the increment tax.

The scope of the levy was wide, as regards both persons and their property. Besides Czech nationals, foreigners after one year of uninterrupted domicile were also included. Diplomatic staffs, &c., and individuals entitled to exemption under international treaties were the only persons excluded. Property abroad owned by resident foreigners was disregarded.[1]

The levy was imposed on the total money value of the property and proprietary rights, after deduction of obligations and debts. Household debts were limited to the amount of necessaries for one year. Household goods, furniture, dwelling-house fixtures, clothes and other objects intended for personal use and not for profit making, pensions and maintenance allowances, claims not yet due on life insurances[2] were all excluded. On the other hand, jewellery and *objets d'art* were included, unless in private collections accessible to the public.

[1] Apart from the personal exemptions mentioned some specified kinds of property (permanently, exclusively, and directly devoted to and actually used for religious, public, charitable, educational, or social purposes) were also exempted. As a general rule, property under the value of Kc. 10,000 was disregarded.

[2] Provided the prospective payment was a capital sum under Kc. 4,000 or a yearly income under Kc. 400.

Private property was valued at the current sale price. This was the normal standard of assessment, with the exception of immovables (houses and land) which were valued by capitalizing their yield. The dates fixed for the necessary double computation and assessment were 1 January 1914 and 1 March 1919. The property as valued in March 1919 was subject to the capital levy. The increase of wealth from January 1914 to March 1919 was subject to the increment tax.

Both taxes were progressive. They were computed separately, and the aggregate represented the total liability of the taxpayer under the law of 1920. The progression of the increment tax increased both with the amount of the property and with the amount of the increment. The rates of both taxes rose in fractions, like those of the British surtax. The rate of the capital levy was 1 per cent. on the first Kc. 25,000, 3 per cent. on the next Kc. 75,000, 6·5 per cent. on the next Kc. 300,000, rising to 30 per cent. on that part of the property in excess of Kc. 10,000,000.

The rates of the increment tax varied from 16 to 5 per cent. on the first Kc. 25,000, from 18 to 8 per cent. on the next Kc. 75,000, from 22 to 12·5 per cent. on the next Kc. 300,000 and so on, the highest rate being 40 per cent. on that part of the increment over Kc. 10,000,000.[1] The levy was assessed on the head of the family according to the aggregate property of all members living in the same household. This was to prevent evasion of the increment tax.

The capital of a concern was valued by taking the value of all its assets at the prices ruling in March 1919, and this was compared with the market valuation of its shares.

[1] In order to make clear the operation of these rates, especially the double progression of the increment tax, let us take an example. *A*, a wealthy taxpayer, has a property valued on 1 Jan. 1914 at Kc. 15 millions. By 1 Mar. 1919 it had increased in value to Kc. 30 millions. The capital levy assessment is as follows: 1 per cent. on the first Kc. 25,000+3 per cent. on the next Kc. 75,000+...+30 per cent. on the final excess over Kc. 10 millions. His increment tax liability is 5 per cent. on the first Kc. 25,000 of increment+8 per cent. on the next Kc. 75,000 of increment+...+40 per cent. on the increment in excess of Kc. 10 millions. *B*, on the other hand, had no pre-war property, but his post-war wealth is valued at Kc. 15 millions. He pays the capital levy on the whole Kc. 15 millions, although, of course, his assessment is absolutely and relatively smaller than *A*'s on account of his smaller wealth. He also pays the increment tax on the whole of the Kc. 15 millions according to the following scale: on the first Kc. 25,000, 16 per cent., on the next Kc. 75,000, 18 per cent.; and so on, reaching 40 per cent. on the increment in excess of Kc. 10 millions. To tax an increment from 0 to x more heavily than an increment from x to $2x$ shows an odd sense of justice.

The rates of the capital levy on corporate property[1] were progressive, rising in fractions:

the first	Kc. 200,000	was taxed at	3	per cent.
the next	Kc. 800,000	,, ,,	5	,,
,,	Kc. 3,000,000	,, ,,	9	,,
,,	Kc. 8,000,000	,, ,,	13	,,
,,	Kc. 15,000,000	,, ,,	17	,,
,,	Kc. 25,000,000	,, ,,	19	,,

the fraction of the property over Kc. 50,000,000 was taxed at 20 per cent.

Both the still evident instability of the credit and market systems and administrative considerations called for very liberal methods of payment. Individuals and corporations alike could pay in any of the following ways: in cash; in the deposit certificates issued in exchange for the bank-notes withheld; out of current and deposit accounts at, and Treasury bills issued by, the former Austro-Hungarian Bank which had been placed under embargo; out of insurance money placed under embargo at the property census; in trustee securities, with the exception of securities of the former Austro-Hungarian Government; or in kind out of sequestrated real estate. The embargo on the property was automatically lifted as it was used for levy payment.[2]

The collection of the levy was to be completed within three years.

[1] The terminology of the Act 'companies and corporate bodies' included a very wide range of bodies and institutions. The term 'companies' meant all incorporated firms, which were obliged to publish their balance-sheets. Private firms were taxed as individuals. The term 'corporate bodies' included public foundations and institutions, churches, orders, congregations, religious societies, and some civic associations. The following were exempted: national property and the properties of local authorities, in so far as they did not own profit-making undertakings under company management, such as breweries, &c ; savings banks; authorized insurance companies; chambers of commerce; and agricultural councils.

[2] The payments, in whatever form they were made, led to the same result, the diminution of the 'State note debt', as the aggregate obligation of Kr. 10 milliards taken over by the Czech State from the Austro-Hungarian Bank, was called. So far as the levy was paid in deposit certificates, the process was very simple: the deposit certificates (and the corresponding withheld bank-notes) represented the very form of debt which the levy was intended to extinguish. When the levy was paid in other forms (mainly in cash), a corresponding amount of the State note debt was cancelled. So far as the levy was paid in land, the Board in charge of Land Distribution paid in the instalments to the Treasury in cash, after collecting the lease or instalments from the tenant or new owner.

Fifteen per cent. of the total amount was due within a month from the issue of the demand note by the revenue authorities; a sixth of the balance was payable within four months, and thereafter a further sixth every six months. In special cases the Minister of Finance was authorized to extend the period of payment up to five years. The urgency of collection was fully realized and pre-payments in cash were encouraged. On pre-payments 10 per cent. interest was allowed, and if the initial payment of 15 per cent. and the first instalment were paid in cash, a further 5 per cent. of the liability was remitted to the taxpayer.

Final collection figures show that the results did not fulfil the optimistic expectations. After initial difficulties high receipts were obtained in 1922 and 1923. In subsequent years receipts were lower owing to the introduction of concessions, but they only declined gradually. The aggregate receipts from the levy and the increment tax during the years 1920–36 amounted to Kc. 7·1 milliards, against a total assessment of Kc. 9·2 milliards (and a rough estimate of expected revenue of Kc. 12 milliards at the time of enacting the levy). In 1928 there were still some Kc. 2·5 milliards outstanding, recorded as arrears. Since then receipts have been trifling and the aggregate of roughly Kc. 7 milliards was regarded in 1936 by the fiscal authorities as the final fiscal result of the operation.[1]

This somewhat disappointing result was almost completely due to the continued economic and political instability, the fluctuations in the value of money, and the initial difficulties of the new fiscal administration. The collection of other taxes was similarly delayed. Two new laws of 21 December 1923 and 15 September 1924, therefore, provided relief and facilities for arrears payments of all direct taxes, including the capital levy. This relief was very considerable; it allowed the spreading of instalments over many years without payment of interest. Wide discretionary powers were given to the revenue authorities. They were authorized to make arrangements with the taxpayer, for reducing the amount of

[1] Comparison of the receipts of the levy and increment tax year by year with the yearly total tax revenue and the total revenue from direct taxes shows that they accounted for an overwhelming proportion of the total revenue from direct taxes up to 1923, were still a third of the direct taxes in 1924, diminishing to a sixth in 1929 and to 1 per cent. in 1936. (Cf. *Ten Years of the National Bank of Czechoslovakia*, Prague, 1937, and *Annuaire Statistique de la République Tchécoslovaque*, Prague, 1938.)

the arrears or even cancelling them, if such payments were likely to endanger his economic stability. The gap between the total amount assessed and the amount collected illustrates the extent to which taxpayers were in need of relief. Falling prices increased the burden of the levy in real terms, and in many cases it became unbearable. This is an apt illustration of the difficulties both of the choosing the proper time for a capital levy and also of fixed valuation, as soon as instalment paying is seen to be inevitable.

The basic law of 8 April 1920 provided that in the first instance the levy was to be devoted to the extinction of the obligations taken over from the Austro-Hungarian Bank. The surplus was to be utilized to meet the most pressing burdens of the Czechoslovak State arising from the establishment of its independence, excluding, however, current deficits in the State budget. The particular purposes within the scope of this proviso, to which the surplus might be devoted, were to be the subject of separate legislation.[1] The administration of the levy was carried out by the Ministry of Finance with the obligation that both its administration and banking should be completely separated from all other revenues of the State.

There is no doubt that the very strict and persistent insistence upon these provisions contributed largely to the success of the levy. A very important part of the State note debt was repaid by the levy which thus fulfilled its purpose to a considerable extent. It did not fulfil it wholly and the collection was spread over a far longer period than was originally contemplated. Still the Czech levy was a relative success in the financial muddle of post-war central Europe.

The example of the new Czech State was followed after an interval by Austria and Hungary. They were inspired by similar arguments, but their levies were far less successful.

[1] By 1925, when the Czech National Bank was established, the total 'State note debt' of Kc. 10 milliards had been reduced by the levy to some Kc. 5·5 milliards. By the law of 12 March 1925 part of the revenue of the levy was released for the redemption of the State loan floated in August 1921, but, on the other hand, certain current revenues were ear-marked for the redemption of the State note debt. This did not essentially alter the character of the operation. The levy was and remained purely a redemption operation. The receipts were never used for ordinary budget purposes.

The Austrian levy had the same main purpose as the Czech—the extinction of the bank-note debt in order to raise the internal value of the currency and to provide the means of acquiring foreign exchange. The Austrians, however, in contrast to the business-like methods of the Czechs, made the fundamental mistake of delaying the operation of the levy. This was mainly due to political difficulties. For some time bitter rivalry between the Social Democrats and the Christian Socialists held up all business. Nor were the prospects of ordered discussion much improved when the rivals had been pressed into an uneasy coalition.

Levy discussion in Austria started almost as soon as in Czechoslovakia. The registration and blocking of different kinds of property on the Czech model followed quickly. By the middle of March 1919 the authorities had a fairly comprehensive view of the distribution of property. But the valuation date of the levy was postponed until 30 June 1920, and it was not until the late summer of 1920, after incredible delay and fumbling, that the levy was actually imposed. In the intervening eighteen months so far from preparations for the levy being actively pushed forward, as was the case in Czechoslovakia, the authorities allowed a heavy capital flight to take place, and the result was that the tide of inflation was soon flowing strongly. The urgency of financing the most pressing State expenditure had completely swamped the debt question. Nevertheless it was still hoped that the levy might at least prove a useful source of revenue. By the time the assessments were made the property register was completely out of date, especially as regards liquid assets. Its only effect had been to increase uncertainty and to hamper business activity.

The original plan of the levy was by no means ill-conceived. It was normally to be paid within three years, with provision for extension to as much as twenty where a very large proportion of the capital was in non-liquid form. The levy was to be imposed on both companies and individuals, but elaborate provision was made to reduce double taxation to a minimum.[1] A Central Loan Bank was set up to facilitate payment, and there was also provision whereby the State Pawn Institute[2] could assist in difficulties over personal possessions and objects of value. During the course of

[1] For a very full and useful account of the Austrian levy, see van Sickle, *Direct Taxation in Austria* (Harvard University Press, 1931).

[2] The Dorotheum.

discussion a number of ingenious administrative suggestions were put forward. But in the interminable wrangling over details the plan gradually lost all coherence.

As finally imposed the levy exhibited clearly the scars of its political battles. The Christian Socialists obtained the exemption of all forms of Church property, and also of certain co-operatives in which they were particularly interested. The Social Democrats were able to free their new public utility enterprises. The suspicion with which big business was regarded was shown by regulations determining the deductions to be made to avoid double taxation. An Austrian subject was allowed to deduct in full the value of holdings in domestic securities from the total of his property. (These securities were, however, taxed at the full flat rate imposed on companies not at the personal rate appropriate to his property.) Companies were only allowed to deduct half the value of their holdings. On foreign holdings (i.e. mainly in one of the Successor States) which had already been subjected to a levy an individual could only make a deduction at the rate of 50 per cent.[1] In the case of bank investments no deduction at all was allowed unless the bank's holding amounted to at least 20 per cent. of the capital of the concern. Further concessions were later introduced for small domestic concerns,[2] and there was provision for special relief for those dependent on small property, pensions, or house rent.

The valuation methods adopted also left room for some favouritism of the small man and of agricultural interests. Valuation was nominally based on current sale price,[3] but the exceptions to this rule were many and important. The small firm was able to value land, buildings, and machinery employed in the business at the original cost. In general land, forests, and buildings were valued on a capitalized income basis, on an average of the net yield of the years 1913–19. With a depreciated currency this already gave some advantage. In addition, in the case of land, it was provided that the annual net yield of the estate on the pre-war land-tax assessment multiplied by 200 would be taken as a minimum, and this figure was in fact generally employed for the levy. The

[1] For companies the corresponding reduction was 25 per cent.

[2] For details, see van Sickle, op cit., p. 149 f.

[3] Securities were valued slightly below market price, holdings of war loan at issue price, but only a proportion of the holding was eligible for levy payment at this price.

multiplier assumed that a tenfold depreciation had taken place. In reality the depreciation was forty-fold, so that the agricultural interests got off very lightly.[1]

The final plan was for a levy on total wealth, including the property of dependants. But certain details signified the intention to make a supplementary attack on the war increment.[2] If the taxpayer could prove the value of his pre-war property, he was allowed a 20 per cent. rebate of the tax due upon it. The exemption limit was set at Kr. 30,000 with allowances for dependants in addition. The rate of tax on individuals was progressive, rising in fractions. The first Kr. 20,000 paid at 3 per cent. The maximum rate of 65 per cent. was reached on that part of the property in excess of Kr. 10 millions. Companies paid at a flat rate of 15 per cent.[3] Liberal terms of payment were arranged. Cash, deposit certificates acquired during the note-stamping operation, long- and short-term government bonds (within limits), and also a wide range of industrial securities were eligible. Indeed companies were encouraged to pay over their shares direct, since the government hoped that it might be able to dispose of them abroad in return for much needed foreign exchange. Payment in kind was also allowed if liability was discharged within three years. Pre-payment was encouraged by a 20 per cent. reduction in liability, and payment in cash by a reduction of 8 per cent.

The whole process of payment was, however, completely thrown into confusion by the rapidly accelerating inflation. Vain attempts were made to expedite payment. The normal period allowed was reduced from three years to eighteen months in March 1921, and the permitted extension from twenty years to ten years. At the end of the year immediate payment in two instalments was required, with increased penalties for postponement. This measure was no more successful than the last. In the early months of 1922 a further decline in the value of the currency took place. As a result the authorities made a last attempt in July to save something from the wreckage.[4] Methods of valuation and assessment were

[1] Cf. van Sickle, op. cit., p. 156. The multiplier also assumed that 5 per cent. was a fair rate of capitalization.

[2] Luxury goods, *objets d'art*, &c., below a certain value were disregarded if it could be shown that they were in the taxpayer's possession prior to the war.

[3] This rate also applied to the Austrian property of non-residents.

[4] In these conditions the Loan Bank never had an opportunity of functioning. The Pawn Institute dealt with only four cases.

drastically simplified. In effect local tax collectors were empowered to make a settlement where a reasonable payment had been made. Laggards were first threatened with a 100 per cent. addition to their arrears, and finally with a 600 per cent. increase in total liability. But before the end of the year the levy had been abandoned. Its place was taken by a small recurrent property tax, imposed as a first step in the programme of reform undertaken by League experts.

The financial reconstruction of Hungary was delayed by the two revolutions, which increased the delicacy of the task. In the post-war chaos, in Hungary as elsewhere, property seemed to be the only proper basis and starting-point of fiscal reform. The capital levy was, however, highly unpopular and too 'bolshevistic' for a country which had just emerged from a Communist experiment. The initial difficulties of the levies imposed in neighbouring countries (including Germany and Poland) alarmed the capitalist classes and were discouraging to the administration. Nevertheless, the financial programme of the Government—summarized in a declaration of the Finance Minister at the end of 1920—included the capital levy. But under the pressure of general opposition a disguised and rather primitive form of levy was adopted. It was to be a levy on separate kinds of property and not on the aggregate property of individuals. The manner in which 'the principle' of this levy was defended is of psychological rather than of economic interest. It must, however, be admitted that it proved acceptable. 'It is not a levy'—it was asserted—'it is the price of property-redemption. The State, which did so much to safeguard property during the war, rightly claims a part of it for its services. It is only just to remunerate the State for its services during the five years of war by confiscating something in the nature of a five years' yield of property. But even this sacrifice is not useless; the money will be used for debt redemption. Thus the rising value of money generously offsets the losses of individuals.' Besides the notorious dislike of capital levies, the deficiencies of the fiscal administration and the urgent need of revenue both tipped the balance in favour of this primitive form of levy.

The technical procedure was on very similar lines to the Czech expedients. Property of all kinds was blocked and registered. It was not released until its owner 'redeemed' his property by ceding

a part of it to the State or by cash payments. The levy, imposed by three successive enactments,[1] covered almost every kind of wealth. It included: (1) current accounts and deposits with the banks, (2) shares of joint-stock companies and co-operative societies, (3) foreign exchange and foreign securities, (4) real estate, (5) vineyards, (6) forests, (7) agricultural equipment, (8) stocks of industrial and other enterprises, (9) objects of value, and (10) Hungarian government securities. Some gross hardships were eliminated by the exemption of objects of minor value. This was also convenient from the administrative point of view. No one principle was followed with regard to valuation and the conditions of payment. Simplicity, or rather the minimum of complication and delay, was the supreme object. The rates were progressive, increasing with the value of the special kind of property, without regard to the other propeity of the taxpayer.[2]

Broadly speaking, in Hungary payment in kind was the basic principle, at least so far as land, shares of companies, foreign exchange, foreign securities, and *objets d'art* were concerned. Payment in kind was, however, inadmissible in the case of working capital and stocks of non-incorporated firms. Even in the case of companies the Treasury preferred cash to shares. Payment in kind was just an emergency measure, due to the inefficiency of the credit apparatus. The exemption of houses, where payment in

[1] All passed in 1921.

[2] A few details will illustrate the methods of assessment. For deposits no special valuation was needed; the levy rates varied between 5 and 20 per cent Property of joint-stock companies and co-operatives was valued by utilizing share prices on a certain date, but only two-thirds of the value thus ascertained was assessed. The levy was assessed on the company and not on the individual shareholders. Payment was accepted in the first place in the shares of the company, with the right to repurchase within a short period. Cash, and some amount of war loan were also accepted, provided the loan had been originally subscribed to by the company concerned. The attraction of war-loan payments lay in the fact that they were accepted at their nominal value, although the market price was far below.

Foreign exchange and securities were taxed at 20 per cent

Estates under 1,000 acres could pay their tax in wheat, in land or in cash, payment being spread over ten years. The amount payable was computed in wheat per acre, increasing progressively with the size of the estate and with its profitability. Experience in the valuation and administration of the established land tax eased the problem Landowners holding over 1,000 acres were compelled to cede part of their estate, which was then available for the purposes of land reform

All other kinds of property were assessed at progressive rates ranging from 5 to 20 per cent.

kind was impracticable, and wholesale mortgage borrowing impossible, makes this evident.

The whole conception of the Hungarian levy presupposed the achievement of a stable money standard after insignificant fluctuations. It was bound to collapse in the case of major changes. Increasing inflation, though facilitating cash payments, frustrated the purpose of the levy. Although assessed on the different kinds of property the levy was computed in value terms, which gave the owners the comforting possibility of redeeming their belongings in depreciated cash. Thus through the inflation the wealthy succeeded in shifting the burden of the levy back to the State, since the nominal value of the collection represented only a tiny fragment of the assessment in real value.

The Hungarian levy, hampered by inflation and evasion, was finally frustrated by the political opposition of the landed classes. In this open obstruction big landowners—the hereditary repositories of political power—and small farmers, just becoming conscious of their political importance, both took part. The resignation of the Minister of Finance was closely followed by the repeal of the provisions. All vestiges of the levy disappeared with the financial reconstruction of the country under the League of Nations (starting at the beginning of 1924). As in Austria and Germany, a current tax on property took the place of the levy. This is still part of the Hungarian fiscal system.

The total revenue of the levy amounted to 120 million Gold Kronen in cash, 472,000 acres in land (in place of the 1·5 million acres estimated) of a value of 200 million Gold Kronen, and some 36·5 million Gold Kronen paid in wheat. According to the basic law the total revenue was earmarked for debt redemption, and the earlier payments were in fact used for this purpose. The growing deficit in the budget led, however, to the repeal of these limitations, and the revenue was released for ordinary budget purposes.

The great fluctuations in the value of currencies concerned—and the changes in the value of the pound as well—render impossible even approximate indications of the figures mentioned in terms of pounds sterling. The magnitude of the operations can very roughly be indicated, however, by the following figures: Czechoslovakia was a country with about 14·7 million inhabitants and (in the peak year of 1929) with a national income of £550

millions. The total revenue from the levy and increment tax came to £45 millions at the same rate of exchange. Austria was a country with 6·7 million inhabitants and (in 1929) with a national income of £220 millions. The total collection from the levy came to £3 millions. Hungary was a country with some 8·7 million inhabitants and (in 1929) with a national income of £210 millions. The total collection amounted to £15 millions. This figure includes that part of the levy which was paid in land and then redistributed, which however, did not mean effective revenue to the Treasury, as the new owners never paid the instalments for them to the State, or at least only an infinitesimally small part of them.

Although these figures are very approximate they are sufficient to show that, whatever may originally have been intended, all three levies were in practice very small affairs—hardly more than capital taxes. They cannot, therefore, have had any decisive economic effect. Economic conditions in all three States at the time were of course very unfavourable for the successful conduct of such a difficult operation as a levy. In the absence of foreign reserves and with the poor prospects of obtaining foreign loans, the States were completely deprived of the means of supporting or managing the external values of their currencies. Exports were still at a low level; industrialists and exporters not only continually evaded foreign exchange regulations, but were strong supporters of further devaluation. Under the pressure of uncontrolled speculation, internal agitation, and increasing budget deficits, a further and progressive deterioration of the internal and external value of the currencies took place.

The relatively favourable position of Czechoslovakia illustrates most clearly the power of these forces. Czechoslovakia—being on the side of the Allies—started the process of stabilization in a far more promising psychological atmosphere, and as a relatively industrialized country she possessed even at the start more material resources than either Austria or Hungary. Her leaders were fully alive to these advantages. The fact that financial reform was undertaken early and resolutely greatly strengthened public confidence. The issuing of new bank-notes was actually stopped and before long the velocity of circulation also diminished. Czechoslovakia was soon able to borrow abroad. Yet all these favourable factors did not bring about immediate stabilization. In the fierce speculation of 1922–3 the whole of the foreign reserves had to be

sacrificed, but the Czech krone was more or less stabilized, and did not follow the Austrian and Hungarian currencies into the abyss of inflation. The capital levy had proved an important and efficient measure for its original purpose.

Figures of post-war monetary conditions in the three States demonstrate Czechoslovakia's relative superiority. The volume of notes in circulation (end of December 1920 = 100) had fallen by the end of December 1924 in Czechoslovakia to 78, while it had increased to 131,549 in Hungary and to 127,370 in Austria. Again, the Czech krone, which was quoted at 1·24 cents in New York in 1921 (average), improved to 3·02 cents in 1924, while the Hungarian krone deteriorated from 0·15 cents to 0·0013 cents, and the Austrian from 0·038 cents to 0·0014 cents in the same period. Price statistics are too inaccurate to give further evidence of the extent of inflation in Austria and Hungary.

It cannot be doubted that the failure to control the volume of money was mainly responsible for the fiasco of the Austrian and Hungarian levies. They provide an unambiguous demonstration of the impossibility of carrying out a successful capital levy unless the value of the currency can be held steady. With progressive inflation the levy ceases to inflict any burden on the taxpayer, whose liability is fixed in money terms, but whose income and property rise in value with the rise in prices. The taxpayer consequently postpones payment until as late a date as possible, and it becomes impossible even to collect the nominal amount of the assessment. In these circumstances the levy receipts are inevitably transferred from their original purpose in a vain attempt to close the gap in the budget.

It was very widely believed in central Europe that the levies were the cause of the inflation which accompanied them. While it is conceivable that in certain circumstances a levy might accelerate an inflation which was in progress, if the government regarded the assessments as revenue, even before they were received, it does not seem likely that the central European levies were of sufficient size to have much effect on the inflation in either direction. Van Sickle's reading of the situation in Austria is that the primary inflation was caused by capital flight before the imposition of the levy—during which period there was no attempt at currency control. After this episode the situation was to some extent brought back into equilibrium, only to be upset again, and more seriously, by

the continued failure to balance the budget. This interpretation would seem to provide a very plausible explanation of the Hungarian situation also. The delay in imposing the Austrian and Hungarian levies thus enormously increased their difficulties.

In contrast to opinion in central Europe, during the British discussions of a capital levy, much emphasis was placed on the probably deflationary effects. There may naturally be some deflationary elements, especially in the announcement and actual process of payment of a levy connected with such phenomena as financial panic, distress sales to make levy payments, destruction of credit, and the attempt to restore the value of property by restricting consumption. It is perhaps worth noting that, in central Europe, independently of the size of the levies, these phenomena were very much less important than they might have been in a more advanced industrial country and in more settled times.

In Czechoslovakia, where deflationary tendencies were strongest, the restoration of confidence as a result of the firm financial measures was so satisfactory that any deflation there was, was quite transitory. The withdrawal of bank-notes, which rested on a somewhat crude version of the quantity theory, was not so disturbing as might have been expected, since many of the notes were already hoarded. Also the fiduciary issue of the new monetary authorities was expanded fairly quickly, so that some of the gap in the currency was speedily covered. The actual process of stamping was of course very disturbing. Frontiers were closed and postal facilities suspended for a fortnight. Difficulties were greatest in retail trade, and many stores issued their own 'notes'.

Monetary conditions, and the method of payment adopted, also contributed to prevent secondary deflation. There was little outstanding credit in any case, and the deposit certificates given in exchange for the withdrawn notes, which were largely used to discharge liability, had expressly been declared ineligible as collateral. The immediate effect of the levy on the credit situation was therefore negligible. Again, there was little evidence of restriction of consumption in order to restore capital values. Wealth had already been so largely dissipated that a complete restoration seemed in many cases a hopeless proposition. It must also be remembered that in these States there is no big rentier class. The wealthy hold their property in real estate, which fared relatively well under the levies. In Hungary house property was exempted.

The small saver is practically non-existent, and the trading community who form the chief saving element managed to restore their balances without apparent restriction of consumption.

Several causes contributed to minimize any unfavourable psychological effects the levies might have had. A capital levy was after all a comparatively mild measure in relation to the shocks of the war and post-war revolution. There was little opportunity for capital flight after the actual imposition of the levies, since the most mobile capital had already left the country, and all three levies were imposed in conditions of exchange control. Although the control was not very efficient, the registration of the property, when it was completed, prevented any further capital flight. Again, it was patent to all that the alternatives to the levy were few, and probably even more undesirable. It would have been manifestly unfair to repudiate the bank-note debt. On the other hand, neither internal credit conditions nor the state of the international capital market gave any hope of raising loans for funding or conversion. Nor was there any prospect of improving the tax yield by other measures. The tax system inherited from the Dual Monarchy was in any case a very poor one, and the fiscal administrations were completely disorganized. Such new taxes as could be imposed and collected were at least as unsatisfactory as the levy.[1]

Records, so far as available, do not indicate conspicuous administrative difficulties in valuation and collection. All three States had previous experience of property taxation, and the relatively simple structure of wealth simplified the valuation problem. Capital assets, such as securities, deposits, life insurance policies, proprietary rights, and intangible property in general, accounted for a very small part of total wealth. It was the valuation of land holdings of perpetual corporations, ecclesiastical foundations, &c., which caused the worst difficulties. It seems that there were no unusual delays in valuation and assessment. Delay was mainly in collection, which was hampered by the rapid changes in money values. In Czechoslovakia there are good reasons to believe that both the unexpected delay over the innumerable instalment

[1] A conspicuous example was the coal tax in Czechoslovakia, an *ad valorem* tax of 42 8 per cent. on the price of coal, which badly hampered industrial activity. Income tax was of little use because it was still imposed on the different sources of income, and not on the global income of the taxpayer. In the event, apart from the levy, most reliance had to be placed on turnover and sales taxes in all three States.

payments and the incompleteness of total collection were almost entirely due to general economic conditions and to the fluctuations in the value of money, and not to the negligence of the administration. There is no reason to doubt the competence and fairness of the Czech administration in the use of their discretionary powers, though some discrimination in favour of Czech nationals cannot be excluded altogether. It must always be remembered, however, that compared with Great Britain, continental fiscal administration meant, and still means, a lower level of equity, yield, and efficiency.[1]

[1] The relative success of the Czech and Hungarian levies were partly due to the initiators of these operations, Alois Rasin and Roland Hegedus, then the respective Ministers of Finance. The great personal prestige of these two notable statesmen was a strong factor in the initial successes of the levies. Both published personal records on their financial reconstruction plans: A. Rasin, *Financial Policy of Czechoslovakia during the First Year of its History*, Oxford, 1923, Carnegie Series. (A very clear and detailed account.) R. Hegedus, 'The Hungarian Currency Experiment in 1921', *Hungarian Economic Review*, 1937, pp. 729–40 (in Hungarian); R. Hegedus, 'The Mystery of Money', *Our Present World*, vol. iii, *The Economic Life*, Budapest, 1937, pp. 428–33 (in Hungarian). Both are interesting retrospective reviews of the motives of the financial reconstruction plan.

CHAPTER XXIV
GERMANY—THE NATIONAL DISTRESS CONTRIBUTION (1920)

By the end of 1919 Germany had already imposed three levies on capital—the Defence Levy of 1913, the Personal Increment Levy which accompanied the excess profits tax for 1916 and 1917, and the Personal Increment Levy of September 1919.[1] In spite of the use of the cumbrous levy machinery, these were all quite small affairs, at least in result. The average liability to the Defence levy was one half per cent. of total wealth, and payment was spread over three years. The progressive scale of the personal increment levy imposed in 1916 had a range of 5 to 50 per cent. The following year it received a supplement of 20 per cent., but even this did not imply a heavy liability. The rates of the increment levy of September 1919 started at 10 per cent., and although they reached 100 per cent. on the fraction of increment over 375,000 M., the average quota was still moderate.[2] It is quite clear that only a very small revenue was collected from any of the increment levies.[3] The State administrations were not able to provide a satisfactory basis for securing equity and preventing evasion, and the Reich administration was only beginning to feel its way. The repetition of the increment method and the provision in the 1919 legislation that any contributions which had been made to previous levies might be deducted from liability, strongly suggest that collection was very inefficient. All these levies might justifiably be described as forlorn hopes of taxing the increase in war incomes.

The National Distress Levy—the *Reichsnotopfer*[4]—passed by the Reichstag in the last days of 1919, was much more ambitious. In Germany as elsewhere, the idea of a capital levy was much in the limelight in the last years of the war. Indeed, as early as 1916 experts of the *Verein für Sozialpolitik* had been asked to study the

[1] See above, ch. xiv.

[2] The exemption limit on the increment was raised in this case, relatively to earlier levies. From 3,000 M. it became 5,000 M. The exemption on total property remained as before.

[3] For total revenue from war taxation, see above, p. 140.

[4] Cf. R. Eichhorn, *Die einmalige Vermögensabgabe im Deutschen Reich* (Jena, 1925) and F. K. Mann, 'Reichsnotopfer' (*Handworterbuch der Staatswissenschaft*, 4th ed., 1925).

application of a levy to the redemption of debt, and other related financial questions. The whole matter was discussed at length at the spring meeting of the *Verein* in 1918.

Discussion[1] revealed if anything a more bitter cleavage of opinion than in Britain. Business interests were extremely apprehensive of the effects of a general levy, and would much have preferred the continuation of excess profits taxes, and if necessary a further repetition of the increment apparatus. On the other hand, the very strong Left and Centre parties were enthusiastic for a general levy which was expected at one and the same time to secure a greater equality of incomes, to deflate and stabilize the internal value of the currency, and to increase the country's competitive power in international markets. In the absence of an experienced fiscal administration there was little opportunity of checking up the various estimates, so that the discussion was carried on in a much more detached and academic atmosphere than in Britain.[2]

Although the Reich was not quite so dilatory with the detailed arrangements for its capital levy as was the Austrian Republic, the depreciation of the mark had already made great headway when the measure was passed. In May 1919 wholesale prices had been at about three times their level in 1913. There then began the rapid slide which brought them to the point of a five-fold increase (above 1913) by April 1920. To this succeeded a period of relatively steady prices until the summer of 1921. In the year following a further five-fold increase took place, and it was succeeded not by a temporary stabilization but by chaos.[3] The valuation date for the levy was fixed for 31 December 1919. Thus from the beginning the administration had to contend with violently unstable prices.

The Distress Contribution was much wider in scope than the armament levy, which is the nearest parallel. The exemption limit of 5,000 M. for single and 10,000 M. for married contributors[4] was lower even in money terms than that for any of the increment levies. The definition of corporation was drawn very widely. It included not merely companies but all legal persons. It was estimated that at least five million assessments would have

[1] The main lines of the discussion are summarized in the *Economic Journal*, 1919. The whole material is reprinted in the archives of the *Verein*, Bd. 156, 1918.

[2] Cf. ch. xxvii, below.

[3] Cf. Bresciani-Turroni, *The Economics of Inflation*.

[4] The levy included the usual family allowances.

to be made. The task was thus an extremely formidable one for any administration, even in settled times.

The levy was to be a final attack on the gains of the profiteer. Purchases of luxuries and *objets d'art* during the war period[1] were to be subjected to a special levy of 10 per cent. in addition to the general levy on all other sorts of capital. The difficulties of collecting tax on such forms of property are notorious. The Reich effort was a complete failure. No effort was made to avoid double taxation of firms and of their shareholders, but, on the other hand, the burden on industry was relatively light. Whereas the rates on individuals were imposed at a fairly steep progression,[2] companies were liable at a flat rate of 10 per cent. In addition 'business capital', which included not merely equipment but also the securities owned by business men,[3] was valued at cost less depreciation—thus much below the current price—and further was taxed only on 80 per cent. of the value thus ascertained. It appears also that the valuation of landed estates was arranged on favourable terms. The basic years chosen were conspicuous for low profits, and the multiplier at which the yield was capitalized was lower than had been usual elsewhere.

The methods of valuation were of necessity summary, and were clearly designed to reconcile the opponents of the levy. But while this meant that only a low standard of equity could be hoped for, it need not have wrecked the levy. Its Socialist sponsors, however, made one big mistake which must have been fatal to it even in much more favourable circumstances. Instead of insisting on payment in full within a very short period, contributors were allowed to spread their payments over a fantastically long time—thirty years, or even half a century in the case of certain landowning capitalists. The inevitable result was to foster the belief that the levy could never be collected. It was a direct invitation to postponement of payment. The fact that 5 per cent. interest was charged on arrears was quite insufficient as a deterrent.

After a year, when the mark was once again depreciating rapidly it was realized at last that payment must be accelerated at all costs.

[1] Things which had not changed hands since 1913 and which were worth less than 20,000 M. were exempt.

[2] Rising in fractions, from 10 per cent. on the first 50,000 M. to a maximum of 65 per cent. on the part of the property reaching 7 million M. and over

[3] Other securities were valued at the quoted—or presumed—price on a certain date.

It was enacted that where liability represented less than 10 per cent. of total wealth, payment must be completed before the end of May 1922. This amendment was estimated to cover some two-thirds of total assessments. The nominal amounts were duly collected by the specified date, by which time the progress on the inflation implied that they represented a negligible burden on the taxpayer, and were similarly of negligible assistance to the Treasury. But that was not all. For the distress levy, as for the increment levies, payment in war loan[1] had been encouraged by acceptance at par. This was a relic of the intention of using the receipts for debt redemption. Since war loan was now heavily depreciated it became a favourite medium for discharging liability. Of the nominal levy receipts nearly 60 per cent. consisted of payments in war loan.

Already before the date arrived for the payment of these limited levy obligations, the government had become convinced of the futility of the operation, and had at last realized the extent to which in inflationary conditions cost of collection devours receipts. Before the end of 1921 the levy was no more. In April 1922 a small recurrent capital tax was put in its place. The Distress Contribution was the culminating failure of German fiscal policy in the days of the old administration. But the chasm of the great inflation had to be crossed before new methods could have a chance of proving themselves.

[1] If subscribed originally by the taxpayer.

CHAPTER XXV

THE ITALIAN LEVY OF 1920

ALTHOUGH Italy was on the victorious side during the last war, she emerged from the struggle with her economy severely strained. As a result of inadequate controls and an inefficient tax system, a considerable degree of inflation had already been reached before the armistice. There was thus a pressing need to overhaul the fiscal system and to recover financial control. Unfortunately the political situation made any such action impossible for some time. The Socialist party in power were anxious not merely to continue expensive subsidies on consumers' goods, in order if possible to allay social discontent, but also to launch out on an ambitious plan of social reform and income redistribution. In these circumstances it was imperative to find new sources of revenue. The air was full of experiments with capital levies, and Signor Nitti determined that this was the social and fiscal solution of Italy's problem.[1] Accordingly in the summer of 1919 the Nitti government appointed a Commission of Experts to study the best method of applying the capital levy idea to Italy.

The commission was a strong one, composed of leading economists and revenue officials. Its mandate was not, as in the case of the British Select Committee,[2] to examine the practicability of a capital levy, but to make a definite recommendation for an extraordinary levy on capital, from which small properties would be exempted and which would include a progressive levy on war increment. It was clear from the first that the commission did not share the government's view as to the advisability of a levy, but they honestly tried to produce the effect of a small levy by other means. Their plan was in two parts. The first was for a forced loan to be imposed at rates varying from 5 per cent. on properties of L.20,000 to 40 per cent. on properties of L.1 million and over. The loan was to bear interest at 1 per cent. and was repayable in sixty years' time. Assuming interest at 5 per cent. this proposal was equivalent to a capital levy of two-thirds of the nominal amount plus a voluntary loan of the remainder. This was made explicit

[1] For this episode Professor Einaudi's *La guerra e il sistema tributario*, cit., is again invaluable.

[2] See below, p. 253.

when at a late stage of the discussion the alternative was introduced of paying 67 per cent. of the nominal assessment and surrendering all titles to the loan. Since the maximum rate of the levy was thus reduced to 26·67 per cent. and progression ceased at the quite moderate property of L.1 million, the proposal could hardly be called revolutionary.

The commission preferred the method of forced loan to that of an open levy for several reasons. In the first place they anticipated that the psychological reaction would be more favourable. This was very desirable since Italy was rather late in the field with capital levy plans, and there had been time for the difficulties of other countries to be observed. They also felt that the eventual repayment would both help to popularize the measure and would tend to increase the accuracy of declarations, since there would be some incentive not to reduce unduly the amount to be repaid to descendants!

The difficulties of imposing an increment levy in Italy were even greater than they would have been in Britain. Not only was there no information regarding property in 1914, but the divided nature of the income tax, the fact that government debt was tax free, and the high proportion of bearer bonds[1] among other securities made it impossible even to estimate income accurately. Under the circumstances there was no alternative but to rely on the figures of the war profits tax, incomplete as they were, and to make such adjustment as seemed possible to cover the categories of income exempt from the income taxes. For the post-war situation it was intended to carry through a complete valuation of property, all businesses being properly valued on a going concern basis. The rates proposed for the increment levy varied with the proportion of the increment. The highest rate (where pre-war capital was zero) ranged from 10 per cent. on properties of L.20,000 (post-war) to 80 per cent. on properties of L.100 millions and over. The lowest possible rate on both taxes taken together was thus 3·33 per cent. (on a L.20,000 property with no increment), and the highest 53·33 per cent. where the property was worth more than L.100 millions after the war and had been zero before.[2] Even this was moderate in comparison with British proposals.

We need not linger over the details of the scheme, which followed familiar lines. The exemption of small properties was

[1] Estimated to be in the proportion of one to four of inscribed stock.

[2] In both cases assuming that the titles to the loan were renounced.

guaranteed by an absolute exemption of L.20,000 (post-tax). To deal with the bearer bond difficulty the commission proposed to tax all such securities at the source at the highest (40 per cent.) rate, thus giving an incentive to the owners both to declare their property and to have the stock inscribed. Assessments were to be made in the first place on contributors' returns,[1] and payment in full was to be due on 1 January 1920. Five per cent. simple interest was to be charged on arrears, but in special cases of illiquidity payment might be spread over eight or even over twelve years, according to the proportion of illiquid assets in the property. Payment was to be accepted in cash or approved securities including certain foreign bonds.

Although the commission's scheme was sensible and practicable it did of course involve a good deal of work, both in connexion with the general valuation of property and in checking contributors' returns. In the autumn of 1919 the main lines of the proposal began to leak out, and the usual storm of abuse and panic immediately arose. To the chorus reciting the difficulties of the small proprietor with all his capital locked up in the business, and the disastrous effect on stock-exchange prices, was added the vigorous protests of the local authorities who were mainly responsible for the bearer bond issues. They conceived, quite erroneously, that they would have to pay the full rate themselves and would only be able to recover from the bond-holders at the lower rates at which they would normally be assessed. They overlooked that in any case they would be able to recoup themselves in the course of a few years merely by withholding interest payments.

As a result both of this opposition and of the amount of work involved in the commission's scheme the government decided to abandon it altogether, and in November 1919 they announced a substitute scheme in four parts. First, instead of the forced loan a voluntary loan bearing 5 per cent. interest was announced.[2] Secondly, a small annual tax on dividends, bond interest, &c., was introduced.[3] Thirdly, a tax on the war increment of wealth was

[1] With provision for declarations on oath whenever it seemed desirable, and for the substitution of official valuations where the return was obviously out of line with observed consumption habits.

[2] This was a great success, but is of course quite irrelevant to the capital levy idea.

[3] Prof. Einaudi calls this the first step in the reform of the fiscal system, but again it has no particular relevance to the war problem.

imposed, and fourthly, a tax on total wealth. The third of these measures produced the tax which we have already examined.[1] The government's scheme was a debased form of the commission's plan, since the scope was once more reduced to that of the excess profits tax, on which it became, as we have seen, merely a surcharge.

The fourth proposal took the form of a thirty-year capital tax imposed at very low rates (varying from $\frac{1}{800}$th on property of L.20,000 to $\frac{1}{120}$th on property of L.1 million and upwards). It was thus different in no respect from the capital taxes which form a normal part of many tax structures and take the place of a surcharge on unearned income. The only remnant of its original nature was that provision for revaluation at certain intervals being included, it was possible to give some encouragement to discharge liability for these sub-periods in a lump sum by offering a small discount.

Although the capital tax thus proposed was of limited outlook it might well have brought in more revenue than was obtainable by more dramatic methods. In practice the possible rate of progression was restricted by the extraordinary inequity of the existing income taxes. But not unnaturally the scheme was quite unacceptable to the supporters of the levy. Consequently in the spring of 1920 the government was forced to return in some measure to the levy idea. They imposed a new 'extraordinary' tax on capital. Valuation was to be made once for all as at 1 January 1920. Rates varied from 4·5 per cent. on property of L.50,000[2] to 50 per cent. on property of L.1 million and over. As payment was ordinarily to be spread over twenty years[3] the annual quota—varying between 0·225 per cent. and 2·5 per cent.—was again little more than might have been expected from an income tax. The tax was a purely personal one, being only levied on firms in very exceptional cases when it was impossible to ascertain the shareholders' holdings. There were the usual exemptions for religious, educational funds, &c.

Valuation was based on a more summary method than that suggested by the commission. Provisional valuations were to be

[1] See above, p. 160.

[2] The rise in the exemption limit probably reflects the progress of inflation.

[3] Where more than 60 per cent. of the property was in liquid form payment was to be completed within ten years.

calculated from income-tax liability in a particular year, adjusted by means of an empirical multiplier. For agricultural incomes the year chosen was 1916 and the multiplier 325; for industrial incomes 1919 receipts multiplied by 25. Definitive valuations were to be based on the then current income. For agriculture this was to be capitalized at 5 per cent., stock being separately valued at market prices. For industrial incomes the capitalization figure varied from 10 to 30 per cent.—the lower figure for concerns using a large proportion of labour. For the valuation of securities average prices for August and September 1919 were taken. Finally 5 per cent. was to be added to the total value thus ascertained, to cover objects of value, and a further 1 per cent. to cover cash. These additions were merely provisional. Declarations had to be made by 31 May 1920, only just a month after the promulgation of the law (at the end of April).

A provision was included in the legislation allowing a discount of 6 per cent. on prepayments. This was naturally insufficient in the circumstances to provide much attraction. Indeed it is obvious that a tax of this nature must be extremely hard to collect in a time of rapidly rising prices. Later it was discovered that the fall in prices rendered the fixed valuations inoperable.

In the spring of 1921 a new wheat subsidy was introduced, and it was proposed to finance this by doubling the rates of the capital tax. In view of the prevailing Communist sentiments no one believed that the increase would be temporary, and the result was therefore both to add to the outcry against the tax and somewhat to retard collection. In the event the doubled rates were removed after a year, but the opposition had managed to increase its influence. Relaxations gradually crept into the administration. It was difficult to resist demands to alter the capitalization multipliers, which had in any case no very high claim to equity or impartiality. For agricultural incomes the basis of valuation was altered to current selling-prices, which were considerably lower than those which it was originally intended to use. The subsequent fall in security prices and the failure of a number of banks created some very awkward situations which could only be dealt with by allowing very easy terms of payment, in spite of the fact that on the whole the real burden at the time of payment was very much less than had been intended.

Receipts from the 'extraordinary' capital tax were moderate

during the early post-war years. A maximum of just over a milliard lire[1] was reached in 1925. Revenue continued to be collected, at a gradually diminishing rate, over practically the whole inter-war period.

Professor Einaudi considers that the administration of the 'levy'—the valuation and the checking of returns—was carried out with fairness and efficiency, so far as it was not impossibly hampered by price-changes. By the end of 1924, of the 295,000 individuals' returns received, 263,000 had been checked. It had been found necessary to write up the total wealth assessed from L.24·7 milliards to L.41·5 milliards, but this was due not so much to understatements by taxpayers, as to the inadequacy of the empirical multipliers.

[1] Less than £10 millions at the then rate of exchange.

CHAPTER XXVI

REARMAMENT LEVIES

(i) *Italy*

In contrast to the experiments and frenzied finance of the war and early post-war years, tax policy in the later twenties was in most countries conservative, with a tendency to lighten the burdens on business at the expense of the consumer. The depression, however, brought with it a double strain on financial systems: on the one hand a serious drop in revenue, and on the other a demand for public works. From this arose not infrequently a more definite turn towards autarchy on the German model, particularly in neighbouring or sympathetic countries. Such policies are inevitably expensive. Although, or perhaps because, the capital levy was traditionally regarded in Germany as an eligible tool of emergency finance, the Nazi régime has so far made no use of it. It is not, however, surprising that the two countries first to revive the idea were in close touch with Germany. Although the Italian capital levy was of too small dimensions to have a decisive economic effect, the fact that it was applied in war conditions adds considerably to its value as an illustration of a tax policy which has some political attractions.

In contrast to Germany, where heavy additional taxation had been imposed in the depression, Italy had to look round for new sources of revenue to finance the accelerated drive for autarchy at home as well as for the foreign adventures of the early thirties. The financial strain was not long in making itself felt. The earlier years of Fascist government had mainly been financed by the tax on *ricchezza mobile*,[1] supplemented by a personal income tax; and by a comprehensive sales tax. During the depression Italy was early in the field with extensive public works. Before the new state investment had become remunerative the Abyssinian war brought a new and heavy strain on the financial system. Whereas up to 1930 the budget had been consistently and easily balanced, from 1931 to 1935 a cumulative deficit of nearly L.30 milliards had been realized. The year 1936 added a further L.16 milliards.[2]

[1] See above, p 156.

[2] For accounts of Italian rearmament finance see 'Italian Finance and Investment' by B. G. Foà and P. G. Trèves (*Economica*, Aug. 1939); and 'Le

No important new taxation was imposed before the Abyssinian war. A 10 per cent. tax was laid on the interest on bearer bonds, which suggests that this feature of the Italian financial structure is still a bugbear to the revenue authorities. In addition, company profits in excess of 6 per cent.[1] on the paid-up capital and reserves were blocked and compulsorily invested in government securities. This may have been an echo of the German blocking measure of 1934, although the idea was not new in Italy. In this form the measure does not appear to have given satisfaction, and the following year it was transmuted into a progressive tax on dividends in excess of 6 per cent., which has remained in operation. Although embodying most of the efficiency disadvantages of a high profits tax, this device naturally commends itself to the revenue authorities and to dividend receivers more than the blocking system. It has something of the same effect in checking rising prices while not destroying industrial liquidity. Apart from these measures deficits were covered by sales of gold and foreign securities owned by Italians, by the revaluation of the reserve after the realinement of the lira (in October 1936), and by other extraordinary transactions.

By the autumn of 1936 it was clear that much more drastic financial measures would have to be taken, especially in view of the pressing and continued need for rearmament. Extraordinary military expenditure and the Abyssinian war had already cost L.29 milliards. The new Finance Minister, Signor Thaon di Revel, at once set about the overhaul of the existing fiscal system, in addition to imposing new burdens. An excess profits tax was introduced, with progression up to 60 per cent. This seems, however, to have been of little fiscal significance, perhaps because of the shortness of the war.[2] The important innovation was a levy on the owners of houses and land, which proved to be the first phase of the rearmament levy.

The Italian rearmament levy was imposed in three quite separate sections—on houses and land, on company capital, and on private firms and partnerships. These were announced and imposed in successive years. Although the intention of thus eventually including practically every source of wealth in the country may have

Prélèvement sur le capital en Italie' by M. Apchié (*Revue d'Économie Politique*, Sept.–Dec. 1939)

[1] Or the average of the three previous years, whichever was the higher.

[2] The maximum rate was subsequently lowered to 30 per cent.

been present from the start, no intimation to that effect was given. It will be seen that the levies were a return to the former inefficient method of making separate assessments instead of a single levy on the taxpayer's total wealth. It was thus impossible to assess them on a progressive scale.

The first levy (5 per cent. on capital value) was in the form of a twenty-five year forced loan, bearing interest at 5 per cent. The service of the loan was secured by an additional income tax (of 0·35 per cent.) to be paid by those who subscribed to the loan. The tax could be avoided by foregoing the interest and treating the loan as a pure capital levy. It was imposed on all owners of houses and land, including dwellings, and industrial, commercial, and office buildings. Mortgage debts were excluded and small properties under L.10,000 were exempt. As in the earlier Italian levies valuation was carried out by capitalizing income—in this case at 5 per cent. In order to simplify payment banks and other credit institutions were instructed to make advances up to 90 per cent. of the total liability, at a maximum of 5 per cent. interest.[1] The levy was justified on the grounds that the devaluation of the lira had increased the value of property, and that it would check the price-rise which might otherwise ensue. It will be observed that a similar sort of forced loan had been suggested by the committee set up to report on the best method of imposing a levy in 1919.[2]

The levy appears to have been fiscally successful. Out of an anticipated receipt of L.8·7 milliards, over L.7 milliards had been collected by the end of March 1938. Of this L.1·3 milliards had been 'redeemed' or paid in levy form. The authoritarian régime enabled the preparations to be made in secret and the levy launched without warning, thus avoiding the announcement difficulties of 1919. The exchanges were also of course completely controlled. Market preparation, and the relaxation of the dividend blocking law, ensured an abundance of liquid funds. Consequently there was little recourse to the banks, except by the larger proprietors.[3] The stock exchange was buoyant, but the note circulation showed no increase and inflationary symptoms did not appear. On the other hand, the

[1] A further facility for the taxpayer was that the advances could be repaid by instalments not commencing until two years after the payment of the levy.

[2] See above, p. 233.

[3] The Bank of Italy lent L.1·6 milliards to banks and credit institutions to enable them to satisfy customers, and advanced about L.4 milliards directly. The banks, &c., advanced some L.2 milliards for levy payments.

demand for land and houses was so brisk that unavoidable sales were carried through without undue loss. The cessation of emigration was no doubt an important factor in this connexion. By April 1937 the prices of houses and land were estimated to have risen by more than the 5 per cent. of the loan interest.[1] Stock exchange prices were said to undervalue prospects heavily. For this the tax on dividends was partly responsible.

The second levy, on company capital, was announced in October 1937. It took the form of an emergency tax of 10 per cent. on the paid-up capital and reserves of companies, reckoned in the first place on nominal value, but corrected by average market quotations in 1936.[2] Property which had already contributed to the 5 per cent. loan was exempt. Investments in State loans were excluded, and 75 per cent. of the value of shares in other companies.[3] Payment was to be made in fifteen bi-monthly instalments, extending from March 1938 to June 1940. A 6 per cent. compound discount bonus was allowed on prepayments.

For the company levy, payment was accepted in the shares of any company quoted on an Italian bourse. Special four months' bills, discountable at the central bank, were created to facilitate payment. Firms still had considerable liquid assets as the result of the dividend blocking, but in order to assist those which could not meet their obligations from reserves, permission was given to write up the capital and issue new shares.[4] Bonus shares to the value of twice the amount of the levy liability might be issued, so long as half the amount was covered by a new issue on the stock exchange. This solution was not attractive to the smaller firms and family businesses, which had no desire to water their capital. The larger companies, on the other hand, quickly realized that the device would enable them both to distribute more to their shareholders without incurring a higher rate of tax, and also to secure higher amortization allowances for ordinary income tax.

[1] Cf. *Economist*, 10 Apr. 1937.

[2] If market value did not exceed nominal value by more than 20 per cent. no adjustment was made. Beyond that point market value was taken, up to a maximum of 160 per cent. of nominal value. If market value was below nominal value, it was also to be used, subject to a minimum of two-thirds of nominal value.

[3] This entailed a considerable amount of double taxation, cf. Mungioli, 'L'imposta sul capitale e la sua incidenza sul risparmio investito nelle società per azione' (*Giornale degli Economisti*, Mar.–Apr. 1939).

[4] It was estimated that companies wrote up their capital by L.6·6 milliards of which L.2·1 milliards were covered by bonus shares.

No figures appear to have been issued as to the extent of bank advances for levy payments, but the Governor of the Bank of Italy stated that they had been considerable, no doubt mainly to the smaller firms.

The levy on companies was estimated to yield about L.5 milliards, of which L.2·8 milliards were paid immediately. In spite of the facilities for payment it seems to have given rise to considerably more difficulty than the levy on real estate. In the first year receipts were only two-thirds of the estimate. The index of stock-exchange values, which had been falling before the announcement of the levy, continued to do so at an accelerated rate. At the beginning of 1938 there was some recovery, but values fell away again[1] when the new shares were placed on the market. Nevertheless the movement was not of very wide dimensions, and government stocks remained steady throughout. By May industrial production was running at a high level, and the import surplus was rising. Whatever deflationary tendency there may have been, ascribable to the process of payment of the levy, and not to world movements which were working in a roughly parallel direction, was soon exhausted. The Italian economy continued to move towards a condition of full employment.

The third levy, on private firms and partnerships, was announced in November 1938. It was of much smaller dimensions than its predecessors and was only planned to yield L.1·5 milliards, but it involved heavier problems of valuation than had hitherto been encountered. In particular, the difficulties of separating the private from the business interests of the taxpayer were considerable. As a result, once again the process of valuation was sidestepped by capitalizing income, this time at 8 per cent. The exemption of property under L.10,000 also eased the administrative problem. The levy was imposed at a flat rate of 7·5 per cent., with a maximum charge of five times the income tax payment of 1938. An element of progression was introduced by means of a system of exemptions diminishing as the size of the property increased.[2] Payment

[1] The index of share values was 120·3 in August 1937, 112·3 in September, 109 in October, but recovered to 120 by February 1938. After the new shares had been placed on the market it fell to 101·8.

[2] A similar device was included in the first Danish excess income tax; cf. p. 166 above. For the Italian levy, for property valued between L.10,000 and L.20,000, 55 per cent. in the case of industry and 70 per cent. in the case of commerce was exempt. The allowance dwindled to 30 and 45 per cent. respectively at L. 50,000.

was ordinarily to be completed in eighteen instalments, extending over three years, but if liability reached four or five times the income tax assessment of 1938 it might be extended over four or five years respectively. No particular difficulties in payment seem to have been experienced.

The receipts for the third levy do not appear to have been separately stated up to the present. In recording the apparent fiscal success of the levies the smallness of their dimensions must be emphasized. Together their total estimated receipt was not more than one-sixth of tax revenue for 1936–8. That more trouble and disturbance was experienced with the company levy than with the others was no doubt partly due to the fact that it synchronized with a world-wide recession, and partly to the fact that L.5 milliards on the industrial sector of the economy represented a considerably heavier burden than L.8·7 milliards on real estate. Italy is still far from being a fully industrialized country.

During the levy years the dimensions of the Italian budget were steadily expanding, as was inevitable with the increasing demands of the African possessions and of Albania. Expenditure in 1938 was nearly L.40 milliards, compared with L.23 millards in 1931. For 1939 it is estimated at over L.56 milliards.[1] The proceeds of the loan and levies have been incorporated in the budget as they accrued, and with their help revenue has been expanded to nearly L.30 milliards. For 1940 further taxation has been imposed, including a general receipts tax on all transactions[2] and a permanent capital tax of 0·5 per cent. on all individual and corporate property, with exemption only for state loans and household goods. Thus once again a capital levy has been replaced by a permanent capital tax. In view of the fact that the banks are well supplied with liquid funds[3] the possibility of a further levy has also been mooted. In addition to these new taxes the fiscal administration has been considerably tightened up. The reforms of 1936 are beginning to bear fruit.

In spite of heavy taxation, of which the burden imposed by the central government alone appears to be about 26 per cent. of the national income,[4] the Italian economy is clearly running at a high,

[1] Cf. *Economist*, 8 June 1940. The Italian financial year ends in June.

[2] Including sales of farm produce, house rents, professional fees, and all types of business transactions. The tax came into force in Feb 1940.

[3] But concern has been expressed at the volume of illiquid assets held by the central bank as a result of the levies; cf. *Economist*, 11 June 1938.

[4] The national income was estimated at L.115 milliards in April 1940 by

if not a dangerous, gear. The note circulation expanded from a level of about L.16 milliards in the years before the Abyssinian war to about L.25 milliards in 1939, although it appears to have been slightly less on the eve of Italy's entry into the war. Considering the extension of responsibilities, if this figure is reliable it does not appear to be alarming. The price-rise is more serious. From 1936 to the outbreak of the war it was estimated at some 50 per cent., and from that point until February 1940 at a further 14 per cent. Since then another 6 per cent. has been added, mainly as a result of the receipts tax.[1] Important wage increases have had to be conceded. Rises of from 6 to 10 per cent. were announced in the spring of 1939, and of 10 to 15 per cent. a year later. On the whole the Italian wage and price control appears to be less successful than the fiscal administration, and much less thorough than the German controls.

Throughout the years of the operation of the levies, with the possible exception of a short period in 1937–8, the Italian economy was either in a state of war or of such intense pre-belligerency as to amount to the economic conditions of war Given expenditure of this order, the result of the levies appears to be exactly such as might be expected. They have fallen in the first instance mainly on capital. Inflationary tendencies have been less pronounced than if a similar expenditure had been financed by loan, but the levies have only provided a very partial brake on rising prices.

(ii) *Hungary*

In the period between the reorganization of its finances by League experts and the world depression, the Hungarian economy progressed at a somewhat dangerous pace. Opportunity was taken of high tariff walls and the foreign capital which poured in to increase the degree of industrialization very considerably. After the depression was over this process was carried further with the aid of exchange control, in order to reduce the value of imports, by importing goods in the raw material stage. The proportion of industrial workers in the country steadily increased, and by 1940

the Governor of the Bank of Italy. This is broadly corroborated by the Italian correspondent of the *Economist*—if the two estimates are independent. In general, estimates of the national income in authoritarian States are difficult to make, since a smaller proportion of the national output comes on the market than in a free economy This may therefore be an understatement.

[1] Cf. *Economist*, 15 June 1940.

about 40 per cent. of the national output consisted of industrial products. A considerable part of this represented the output of new industries and of industrial capacity established after 1932. It is noteworthy that the banks took a smaller part in financing this expansion than had been customary in Hungary, as it had in Germany, in earlier periods. The new investment was mainly financed from company reserves.[1]

In the winter of 1937–8 the process of expansion showed definite signs of slackening, and since world conditions seemed to be moving in the same direction under the lead of America, it was decided to launch a bold programme of public works. A plan was accordingly brought out early in 1938, which envisaged the spending of Pengö 1000 millions over five years, partly on schemes of social amelioration, and partly on rearmament. With a national income of P.4,500–5,000 millions[2] and a normal tax revenue of some P.900 millions, this meant that the government would be spending somewhat over a quarter of the national income, by no means a large proportion for exceptional times. There was good reason to suppose that the country had attained a state of sufficient industrialization for a public works campaign to have a fair prospect of success. The years of prosperity had left industry with plenty of liquid funds. It was decided to raise the money partly by a voluntary loan of P.400 millions, bearing interest at 5 per cent. and issued at 96, and partly by a capital levy on total private and company capital, to be called the Investment Contribution. The measure was justified on the familiar grounds of combating unemployment and utilizing idle capacity.[3] In order to reassure taxpayers it was intimated that payment would be facilitated by advances on easy terms by the Central Bank.

Unlike Italy, Hungary already possessed fairly elaborate machinery for valuing real estate, in the annual property tax. This was a heritage from the Dual Monarchy, and served in a country where property was mainly held in the form of land, as an

[1] These had been considerably expanded as the result of high profits made behind the tariff walls. No doubt the moratoria on foreign indebtedness also played a part.

[2] Cf. *World Economic Survey*, 1938–9, p. 84.

[3] Cf. J. Judik, 'The Economic and Financial Aspects of the Five Years' Plan (*Hungarian Economic Review*, 1938), and A. Navratil, 'Public Works' (*Principles of Economics*, vol. ii, § 30, 1939) (both in Hungarian).

additional income tax on unearned income.[1] The property tax is levied on all forms of landed estate, whether in individual or corporate ownership; on the assets of industrial, agricultural, and forestry concerns; and on personal property, including securities, deposits, and cash, and excluding only household goods.[2] Valuation is based on current sale price on the last day of the year, or for some types of property on the capitalization of income. All property in excess of P.5,000 is liable to the tax.[3] The global family income is assessed as one, and debts, including the capitalized value of pensions contributions, mortgages, and similar payments can be deducted.[4] It needed little adjustment to utilize this machinery for the capital levy.

The levy was assessed on all property belonging to Hungarians, both at home and abroad (except movables abroad), and on all property in Hungary owned by foreigners, subject to the current property tax and worth more than P.50,000 in February 1938. Institutions and funds with property of similar amount were also liable, even if they were not subject to the property tax. Exception was made only for the funds of the State and local authorities, including social insurance and pension funds and for the pensions funds of industrial concerns. In practice the current sale price method was used for the valuation of securities[5] and movable property, also to some extent for industrial equipment and working capital, and for property that had recently changed hands. For other sorts of wealth the capitalization method was used. Real estate was valued by capitalizing the net return per acre, with complicated adjustments to allow for differences of location, size of holding, type of crop, &c.[6] Houses were valued by multiplying the net rent[7] by 13. A particularly disputed point was the treatment of the many new houses which had been built under an exemption from the house tax. Not merely were these included in the levy, but they were also assessed on the capitalized value of the tax exemption.

[1] Theoretically the tax is a recognition of the services of the State in protecting the sources of income, but it is levied, of course, whether there is any income from the property or not [2] Books and works of art are also excluded.

[3] Or P.25,000 for those exempt from income tax, including civil servants.

[4] The tax is levied at progressive rates, rising from 0·1 to 1 per cent. (on a net value of P.19 millions).

[5] Being the market price on 28 Feb. 1938.

[6] The value of the equipment was determined by the value of the estate and varied from 4 to 8 per cent. according to the type of production.

[7] Gross rent, less house tax and supplements.

Non-incorporated firms were valued on the basis of their balance-sheets if accounts were kept regularly, otherwise the capitalization method was used. For this purpose it was presumed that firms with a profit of P.5,000, and using a fair amount of working capital, must have a capital of P.50,000. For the valuation of non-quoted shares the assistance of local Chambers of Commerce was called in, and in doubtful cases the official Institute for the Control of Commercial Banking. Besides the deduction of debts, and the capitalized value of pensions contributions,[1] insurance policies were exempt, but prepayments over one year's charges were included in capital.

Just as the property tax formed the basis of the levy on individuals, the machinery of the corporations tax was turned to account for the levy on companies. The corporations tax is very comprehensive, and covers all incorporated undertakings, including limited companies and co-operatives, whether under Hungarian or foreign control; and all public utilities whether publicly or privately owned. The only exceptions are a few enterprises of national importance such as the Post Office Savings Bank and the State Railways; and a few local utilities of a non-profit earning nature or whose development is especially favoured, such as public hospitals, waterworks, and communal electricity concerns.

The valuation of companies for the levy is an attempt to get at the true value of the capital employed. In the first place the paid-up capital plus reserves is taken, less any losses sustained up to the end of the accounting period ending before 1 January 1938. Since according to Hungarian practice the results of any bonus operations are, or should be, found in the open reserves, this is supposed to give a true return of the capital. In order to provide a check the gross profits for the last three years are capitalized by multiplying by 25, and the two estimates are then averaged. In any case, however, the tax is not to be levied on a value below 80 per cent. of the paid-up capital plus reserves (or 70 per cent. if losses have been deducted). Similarly, it will not be levied on a value above 150 per cent. of the same nominal capital.[2]

Both parts of the levy are imposed at progressive rates, levied on successive fractions of the property. For individuals the first frac-

[1] The annual contribution multiplied by 20.

[2] In Hungary, as elsewhere, the question of related companies has given rise to great difficulty. The measures concerning them seem to be more complicated than illuminating, so that we have made no attempt to interpret them.

tion, between P.50,000 and P.56,250 is taxed at 5 per cent. The fraction over P.1 million is taxed at 14 per cent. The average burden is thus quite moderate. For companies the first fraction, up to P.100,000, is taxed at 10 per cent., and the progression proceeds by large steps to 20 per cent. on the fraction over P.5 millions. Two modifications in the system provide some relief for hard cases. For individuals the marginal increment is relieved to the extent that the fraction of property which would strictly be liable to a higher rate is charged only on 50 per cent. of the amount. Secondly and much more important, three-eighths of the value of the land and working capital of agricultural concerns, of bonds, and of shares in Hungarian industrial companies is allowed as a deduction. The concession to agricultural interests was mainly political in origin, and was justified by the 'agricultural crisis'. The bond concession was an effort to give psychological support to the (still very small) capital market. The concession on shares, on the other hand, was due to the desire to reduce the burden of double taxation. In all cases the remainder of the property is taxed at the full rate appropriate before the calculation of the deductions. As a set-off against these concessions it was decided in May 1940 that the levy should be extended to 'Brain Capital' by means of a supplement of 40 per cent. on the income-tax liability, imposed for five years on taxpayers whose income exceeds P.10,000 although their property is under P.50,000.[1]

The assessment to both parts of the levy is made in the first instance on taxpayers' returns and will be subsequently checked by the revenue authorities. In order to discourage fraudulent declarations concerning objects of value, the authorities were empowered to requisition them within a year. In practice this provision was found to be too drastic and has been modified. Payment of the levy is due in twenty instalments, extending over five years, beginning at 1 October 1938. The period may be extended to six years where taxpayers are dependent on agricultural incomes, and even to as much as ten years for certain agricultural interests, including the bulk of the large landowners and a good deal of ecclesiastical property. Normally the levy has to be paid in cash, and 6 per cent. interest is allowed on prepayments. If taxpayers

[1] Individuals whose annual assessment to the levy is less than 10 per cent. of their income are included but in their case the levy assessment will be reduced by one-fifth annually, in order to avoid double taxation.

fall into arrears by as much as four instalments the revenue authorities can order the payments of arrears in immovables, up to one-third of the property, provided that sufficient resources are left for the proper conduct of the farm.

It is naturally impossible to give more than an interim indication of the economic effects of the plan, particularly as the operation itself is not yet completed. In any estimate the results of the loan and the levy must be considered together. The two measures were intended to be complementary since the loan was planned to absorb the balances of pension and other funds which were exempted from the levy. In practice the loan has assumed a semi-compulsory character. It was laid down in the original legislation that more than half the levy must be paid by corporations. Pressure has been brought to bear on companies to invest freely in the loan, and to refrain from selling the scrip once acquired. The economic effects of the two measures are thus very similar. In the course of eighteen months to January 1940 P.410 millions of the loan was issued in three instalments. Of this total the banks and industry absorbed rather less than a third each, and insurance companies and the funds of public departments rather more than a third. The Central Bank has refrained from making advances on the scrip, and the aim of absorbing the funds appears to have been fairly well achieved.

Total assessments to the levy amounted to over P.700 millions, or more than P.100 millions above expectations.[1] Up to the end of June 1940 seven instalments, totalling about P.250 millions, had been paid, so that there appears to have been little delay in collection. Payment was facilitated by the Central Bank providing ready rediscounting facilities to the commercial banks to enable them to assist clients. These facilities have been widely used even by the larger banks which hitherto have maintained their independence of the Central Bank. A further device has been the opening of a new public institution—*de facto* a department of the Central Bank—to maintain a flow of funds by open market policy.

In addition to the revenue from the loan and the earlier instalments of the levy, the government has raised some P.50 millions in Treasury bills. This implies that within two years some 70 per cent. of the P.1,000 millions planned for has been spent, or at a rate

[1] Cf. *Quarterly Reports of the Hungarian Institute for Economic Research*, esp. Feb. 1940.

somewhat in advance of the original plan. This rapid expenditure is partly the effect of the expansion of the national frontiers, but mainly reflects the shift in weight from social amelioration to rearmament. The additional expenditure probably represents something over 5 per cent. of the national income, and although the total is still moderate compared with many countries, it is no doubt sufficient to affect the tempo of the economy. It seems evident that the payment of the levy has been accompanied by a not inconsiderable amount of direct credit expansion. The whole measure must therefore have resulted in very little restriction of consumption. Moreover, taxation of current income and expenditure is still on a relatively moderate scale—certainly not above 20 per cent. of the national income. It is thus not surprising that expansionary symptoms should have appeared.

The index of industrial production rose from 129·5 per cent. in 1937[1] to 151·4 per cent. in 1939. The number of industrial workers increased by more than 110,000 in the same period. Meanwhile the note circulation has roughly doubled, but this must largely be explained by the increase in hoarding and in cash balances—the one on account of the general strain and uncertainty, and the other due to the genuine needs of the new territories. There has also been an increase in the bill holding of the Central Bank (from P.450 millions at the end of 1937 to P.600 millions at the end of February 1940); and a rise of the item 'other creditors' in the balance-sheets of the seven main banks, representing the activities of the new credit institution. On the other hand, the price rise has been negligible as measured by the official index. The control of raw materials has been extensive, and it is said that the large volume of State orders has helped to keep contract prices low. Thus it would appear that the combined effect of the controls and of the general state of tension have prevented the full effect of the expansion of public expenditure from being felt, much in the same way as if a state of actual war had existed.

[1] 1929 = 100. Cf. *Quarterly Report*, Feb., cit.

PART VII

THE IDEA OF A CAPITAL LEVY IN GREAT BRITAIN

CHAPTER XXVII

THE LEVY REJECTED (1919-27)

DURING the war of 1914-18 there was little mention of the use of a capital levy as a measure of war finance,[1] but the discussion of a levy as a means of lightening the burden of the debt was already active well in advance of the cessation of hostilities. As the year 1918 took its course there was a growing awareness of the approach of the end of the war. With this came the realization by thoughtful opinion on several sides of the perilous state in which the country's finances would be found when the day arrived for its financial house to be put in order. By the spring of 1918 the war debt had already reached over £6,000 millions, and wholesale prices were 132 per cent. above those of 1914. To extricate the country from this position was obviously going to be a dangerous and difficult task.

Reasoned discussion of the desirability and practicability of a capital levy may be dated from an important speech by Mr. (afterwards Lord) Arnold in the House in the spring of 1918.[2] This was backed up on the Labour side by Mr. Pethick Lawrence's book *A Levy on Capital*, published the same year, and by a number of articles and memoranda. Of somewhat different intent but of equal importance was Professor Pigou's contribution to the *Economic Journal* of June 1918—'A Levy to discharge War Debt'. From these discussions two points emerged which are fundamental to the British idea of a capital levy. In the first place attention was concentrated on a levy whose sole or main purpose would be the reduction of the war debt. Secondly, from the beginning the idea was supported both by socio-political and by economic arguments. These two lines of thought were entirely separate, although naturally many individuals held a blend of both.

[1] Although it was suggested by Snowden as a means of raising additional taxation as early as 1915. It does not appear that he had given any thought to its detailed implications; cf. Stamp, *Taxation during the War*, p. 65.

[2] Cf. the remarks of Stamp, op. cit., p. 128.

In the absence of rigorous price and wage control the dispersion of incomes had of course become very striking. In 1918 the war profiteer was a very conspicuous figure. It was undoubtedly the rough justice of taking his wealth if you could not take his life that made the widest appeal in favour of a capital levy. The most important argument in the minds of Labour supporters was that the heavy debt service would curtail the development of the social services, but they also conceived the levy as a useful step in the fundamental policy of income redistribution. The economists were chiefly concerned with the effects of the taxes required to meet the service of a large volume of deadweight debt—which it was expected might reach £8,000 millions before the war was over—in postponing financial reorganization and sapping economic incentive.

For a levy to have any substantial effect on the war debt it was clearly necessary to draw upon the total wealth of the country, and this was what Professor Pigou advocated. But the idea which gradually gained ground was for a levy on the increase of wealth during the war, thus specifically on the profiteer. A Select Committee[1] was appointed to examine the practicability and effects of such a levy. It did so with much thoroughness in 1919–20, examining a large number of witnesses and extracting five valuable memoranda from the Inland Revenue. It was quite evident that the very idea of such a fiscal innovation was repugnant to large sections of the British public, by no means only the wealthiest. Moreover, the experience of foreign countries which had attempted to impose levies was anything but encouraging. Nevertheless the Revenue Authorities conceded that a levy was administratively practicable, and the committee reported in favour of a definite scheme in the event of it being considered essential to redeem some of the debt immediately.

This rather surprising result was undoubtedly influenced by a suggestion, supported by financial experts, that while a levy on the increment of wealth could not be large enough to redeem any important part of the debt, it might at that particular moment be made to serve a very useful purpose in monetary policy—namely the reduction of the floating debt.[2] The Treasury Bill issue had

[1] *Select Committee on the Increase of Wealth (War)*, 1920.

[2] Thus Sir B. Blackett argued in a memo. submitted to the Select Committee that the levy would reduce the floating debt without raising the burden of the total debt, as would occur if the floating debt were funded and prices

expanded to more than £1,000 millions in the autumn of 1919 and was not reduced below that figure until January 1922. To many in financial circles the situation seemed completely out of hand. It may be doubted whether the financial outlook was really so bad as appeared from the volume of Treasury bills, which had partly been swollen in the course of a (successful) manœuvre to clear the market of excessive cash.[1] The resolution of December 1919 controlling the note issue, and the balancing of the budget in the next financial year are definite proofs that the monetary authorities were fundamentally in control of the situation.

It must also be remembered that the Select Committee reported before the E.P.D. fiasco of 1920–1. The 'War Profiteers' of 1918–19 were probably mainly people who had increased their wealth during the early years of the war, before adequate controls were imposed and when the rate of E.P.D. was low. The high profits of the final year of the war and of the post-war boom can only have been distributed to a very small extent, at the time the committee reported. If, as was expected, E.P.D. had been repealed at an early stage, large additional profits would have been due for distribution, and would greatly have strengthened the case for an increment levy.

The scheme for an increment levy, for the practicability of which the Inland Revenue vouched, was confined to those individuals whose property exceeded £5,000 at the end of the war. They rejected the plan of imposing the levy on companies, not apparently on account of the danger of double taxation, but owing to the difficulty of estimating the true value of corporate property. They pointed out that since the market value of shares might diverge considerably from the true value of a business as a going concern, to use the former as a criterion of capital value would not be equitable. Again, in addition to short period and other chance effects, market price might be affected by dividend policy. Further, changes in the rate of interest affected companies unequally according to differences in capital structure. The significance of these objections was undoubtedly that in the still unsettled conditions of 1920 it was impossible to make a good estimate of business

subsequently brought down to the U.S.A. level, as was assumed to be desirable by financial authorities.

[1] Cf. A. T. K. Grant, *A Study of the Capital Market in Post-War Britain*, pp. 72 ff.

prospects, and hence of the margin between true and market value. At a later stage some of these arguments would have had less force. The Inland Revenue conclusion is of great importance, however, as it effectively ruled out of further discussion any idea of extending a levy to corporate property. If a levy had been imposed in Britain it would certainly have been of the milder type—in respect of restriction of enterprise—of a purely personal tax.

It was proposed to carry out a double valuation of property—at 30 June 1914 and 1919 respectively. It was, of course, realized that the data for making the earlier valuation was very scanty and that it would have to be mainly guess-work. Two alternative schemes for taxing the increment were suggested: one based on the absolute amount of the increment and the total post-war wealth, the other on the pre-war wealth and its percentage increase. The first thus put the greater weight on riches, and the second on their expansion.[1] Both were planned on a fairly steep progression to produce a revenue of about £1,000 millions.[2] When the Select Committee came to review this plan they felt that the exactions were too drastic. They therefore proposed that a number of special reliefs and abatements should be introduced which would not only have given extra allowances on an increasing scale for small properties but would have permitted special treatment of those who had suffered personal bereavement during the war. In valuing small businesses special account was also to be taken of the profit prospects. The effect of these reliefs would have been considerably to simplify the administration. The number of taxpayers would have been reduced from some 340,000 to 75,000. Investments in land, buildings, and farm stock would have been exempt since their value had increased less than the abatements. (Owner-occupied houses were already exempted in the Inland Revenue scheme.) It was only on this much reduced basis that the Select Committee were prepared to give their limited blessing to the increment levy. Its revenue was somewhat optimistically estimated at £500 millions.

In the disturbed circumstances of 1920 it is extremely doubtful

[1] Continental experience suggests that the first method is on the whole less likely to lead to serious anomalies; cf. above p. 214 n.

[2] As shown in the Inland Revenue Memorandum, the first scale was slightly less productive, and the progression somewhat steeper.

if any sort of levy could have been carried through sufficiently quickly to deal with a transitory situation such as the embarrassment of the floating debt. In the event, the slump of 1921 intervened, and in it disappeared both much of the war wealth it had been proposed to tax and the complacency of financial interests in respect of the levy.

The principle of a capital levy was nearer to realization in 1920 than at any other moment. As the war receded in time, the arguments in favour of a levy on war wealth became steadily less relevant. The idea of a general levy was still supported by a number of economists on the grounds on which they had originally favoured it, but with fading conviction, as the possibility of lowering income tax,[1] and the ability of the country to sustain the debt service without undue effort became apparent. These years were, however, used by the Labour leaders[2] to develop more fully the scheme for a general levy to redeem a large part of the debt. Discussion was very lively, with the political element coming increasingly into the foreground. The growing industrial troubles and widespread social unrest convinced many, not only in the ranks of the Labour party, that some drastic step such as a levy was almost inescapable. When in March 1924 the Colwyn Committee was appointed with a mandate 'To consider and report on the National Debt', they naturally made it their business to interview representatives of all shades of opinion interested in a levy on capital.

Unfortunately the time was not very propitious for gathering clear and objective evidence as to the practicability and probable effects of a general levy. Most of the witnesses were interviewed during the spring of 1925, when on the one hand the labour situation was rapidly deteriorating, and on the other the expected restoration of the gold standard, but complete ignorance as to how it would function, made it particularly difficult for economists and financial experts to make intelligent forecasts. It is also regrettable that the Inland Revenue contribution was confined to some short appendixes and notes to their earlier memoranda. They did not fully examine either the technique or the effects of a general levy. It at least required some justification to assume that conclusions

[1] The extent to which interest payments would return to the Exchequer in the form of super tax receipts, owing to the progressive distribution of debt holdings, had probably not been realized. Cf. below, p. 287.

[2] Among Labour writings, Dr. Dalton's contributions (such as *The Capital Levy Explained* (1923)), and passages in *Public Finance*, were especially acute.

reached in respect of an increment levy would hold equally for an operation about six times as large.

In the course of general discussion very different opinions had been put forward as to the desirable magnitude of a general levy. Suggestions ranged from about £6,000 millions—or a sum sufficient to redeem the greater part of the war debt—to £1,000 millions[1]—an amount which could be guaranteed not to be too disturbing in any circumstances. Since the Colwyn Committee were, unlike the Select Committee, not concerned to pronounce on any particular scheme, they decided to concentrate discussion on a levy to bring in a maximum of £3,000 millions, or enough to redeem about half the debt. It appeared that this figure was both about the largest that could be regarded as administratively and economically practicable, and the minimum sum that would be worth while in the sense of having an appreciable effect on the war debt. No special emphasis was placed on the manner in which this sum should be raised. Dr. Dalton expressed a general feeling in suggesting that the scale chosen should be subservient to the yield aimed at.

Throughout the Colwyn discussions it was generally agreed that the levy should be imposed only on personal property.[2] The Inland Revenue arguments against including companies were thus accepted. Indeed, in the state of trade which existed during the time the committee was taking evidence, it was clear to all that if a levy were to be imposed it must be so arranged as to cramp industrial enterprise as little as possible. It was generally agreed that there should be a minimum exemption limit, but considerable difference of opinion was expressed as to where the line should be drawn. Considerations of equity seemed to indicate £1,000 as reasonable, and many Labour leaders were anxious that it should be fixed no higher. A low exemption limit, even if coupled with a very mild progression at the lower end, would probably have considerably increased the chances of acceptance of the levy by the wealthier classes. Some of the trades union spokesmen, on the other hand, seem to have been doubtful of the acceptability of such a low figure to their supporters. They were correspondingly anxious to emphasize both the difficulties of valuation of small properties, where private businesses are an important item, and

[1] This was the suggestion of Prof. Macgregor.

[2] Professor Pigou was in favour of extending it to cover brain capital, if practicable, but most supporters were agreed that it was not practicable.

also the high cost of collecting tax from small contributors. The exemption limit of £5,000 had been put forward for the increment levy, and for the general levy the advantages of a relatively high exemption limit were naturally even greater. It was estimated that the number of individuals with property of £5,000 and upwards was about 500,000, while if the limit were to be fixed at £1,000 the number of assessments would be trebled. The minimum of £5,000 was therefore taken as the basis of discussion, equity giving place to practicability.

It was unanimously agreed that in order to obtain a sum of £3,000 millions in an acceptable manner the levy would have to be imposed at steeply graduated rates. The Labour party[1] had put forward a scale of progression which ranged from 5 per cent. on the first £1,000 in excess of £5,000 to 60 per cent. on that part of the property which was over £1 million. The Inland Revenue estimated that for this scale to bring in a nominal £3,000 millions the rates would have to be increased by one-fifth, making the progression from 6 to 72 per cent. on successive fractions of wealth. The scale suggested rose by even steps. The burden on middle-grade properties (between £8,000 and £20,000) was thus already considerable. Examination of other possible scales[2] showed that this could only be avoided by increasing the rates on the highest fractions to 100 per cent. or more. The Inland Revenue pointed out that these estimates were based on pure arithmetic, and made no allowance for evasion, default, or other difficulties. In practice, therefore, the rates would have had to be considerably stiffened in order to secure the desired revenue. In comparison with the majority of foreign levies, the general levy as planned would thus have been a formidable operation, and would have imposed a heavy burden on the saving and property-owning classes.

Whatever the gross amount aimed at, the really significant magnitude was the extent to which a levy would permit of a reduction of taxation—or alternatively an extension of expenditure at existing tax rates. In the early discussions extravagant claims were made, such as that the levy would enable the entire debt to be redeemed, and leave in addition a margin for the extension of social expenditure. As soon as it became apparent that the increment levy would not be put into operation more careful analysis of the practicable net yield of a general levy began to be made. One

[1] Cf. *Labour and the War Debt.* [2] Cf. *Colwyn Report*, p. 252.

of the most thorough calculations from the Labour side was an article appearing in the *Highway* in the spring of 1923. Gross saving in debt service was estimated at £140 millions, loss of future tax revenue at £82 millions, leaving a net yield of £58 millions. Dr. Dalton estimated net saving rather more optimistically at £72 millions.[1]

The first really thorough estimate of loss of revenue as a result of a levy was that of Sir J. Stamp, published in the *Contemporary Review* in January 1924. Stamp's method of calculation differed from previous estimates both in respect of super-tax, where he worked out in detail the pre- and post-levy position for each income group; and still more decisively in respect of death duties. In their case he not only estimated the loss of contribution for each property and age-group, but also pursued the loss of revenue to the second turnover of the estate. He was thus able to estimate the total tax loss for the duration of the debt.[2] Stamp's conclusion was that about two-thirds of a levy would, at existing tax rates,[3] be required to 'pay for its keep'. In other words, for every £100 of gross saving some £65 of future revenue would be lost, leaving only about £35 to play with (and even that amount assumed 100 per cent. collection). The order of magnitude of this calculation was substantially confirmed by the Inland Revenue.

Stamp's estimates were made without reference to existing sinking funds or to the desirable sinking-fund policy which should accompany a levy. It would seem that in the conditions of the twenties, when substantial sums were being set aside annually in sinking funds, his estimate of the practicable reduction of tax rates was unduly pessimistic. His main point was, however, clear and convincing. The British system of progressive taxes was already of such an order that a progressive capital levy was necessarily to a very considerable extent merely an anticipation of revenue. The result of Stamp's demonstration was that most economists who had hitherto given the principle of a levy their support, now abandoned it as not worth while.

It was no doubt partly this change which accounts for the

[1] This seems to have been due to a misapprehension of the effect of repaying external debt Although no direct tax revenue may be lost if the loan is tax free, the deflationary effect of the repayment of external debt is, of course, much greater, and the indirect loss of revenue certainly not less, as Stamp had little difficulty in showing (op. cit. p. 253).

[2] For further discussion of this estimate see below, ch. xxix.

[3] i.e 1921.

somewhat unreal atmosphere in which the Colwyn Committee discussions concerning the economic effects of a general levy were conducted. It must also be remembered that by 1927, when the report was published, the Labour crisis had passed, and there seemed consequently to be less urgency for a levy on social grounds. The gold standard also appeared to be working satisfactorily, and there was no general apprehension of a price fall due to external events. The arguments for a levy thus seemed to be considerably weakened.

Since the first charge on the levy would have been the redemption of debt, it would have had an inherently restrictive bias. In the discussions there was much talk of inflation and deflation, but little analysis of the conditions under which one or the other might be expected to predominate. It is impossible to avoid the suspicion that witnesses just hoped that the levy would be inflationary (or deflationary) according as they favoured the one or the other, or thought the levy itself advantageous or dangerous on other grounds. In some cases where well-informed witnesses differed in their analysis they were frequently basing it on implicitly different assumptions. The discussion of two points in particular, both concerned with the actual operation of the levy, suggest both an inadequate appreciation of the problems involved and also considerable difference of opinion as to how they should be handled. These were the methods of payment to be allowed, and the application of the receipts of the levy.

It is evident that both committees and also their witnesses had in mind a genuine levy of which the greater part would be paid over at once. The question of revaluation if payment had to be spread over a period was not discussed. On the other hand, recourse to instalment paying on a fairly large scale was clearly expected. Professor Pigou had been prepared for this in his 1918 scheme, in spite of a somewhat optimistic estimate of the volume of liquid assets.[1] The Select Committee would have allowed payment of the increment levy to be spread over ten years in case of need. Lord Arnold, who was specially concerned to emphasize the ease with which a general levy could be paid, suggested that payments might be spread over sixteen half-yearly instalments in hard cases.[2] Professor Scott would frankly have preferred to substitute

[1] Cf. below, p. 270.

[2] Cf. *Economic Journal*, June 1918.

a ten-year tax.[1] The feeling of the Colwyn Committee on this point does not appear to have been very definite, but there is no evidence that they thought of setting any precise limit to instalment paying. Continental experience affords clear evidence of the difficulties both of valuation and collection when instalment paying becomes at all general.[2] The general effect is admittedly to reduce restrictive tendencies, but in an undesirable and inequitable manner.

Supporters of the levy were also prepared to advocate considerable use of bank credit in order to surmount the difficulties of payment. While it was recognized that the additional credit would be anti-deflationary, and would allow levy payers to meet their obligations without reducing consumption in the immediate future (this point was specially emphasized by Mr. Keynes),[3] the further probable effects of bank advances tended to be underestimated. Governments may sometimes be made to change their minds about exacting long-term obligations, but the banks who would have thus become tax farmers would not have been likely to forgo their interest and principal. This method of payment may thus ultimately be considerably more restrictive to enterprise than was allowed for by the investigators.

The Labour party do not seem to have been greatly exercised as to the precise application of the receipts of the increment levy. From their point of view it was a secondary matter. Financial supporters were unanimous in suggesting that the receipts should be applied to the reduction of the floating debt, since this was in their opinion the main justification of the levy. There was little apprehension of deflationary effects as a result, since it was intended in any case to follow a deflationary policy for the sake of the exchanges. By 1925 the difficulties of the money market owing to the reduction in the Treasury bill issue, and the considerable fall in the three months' rate, had completely altered the outlook. In the Colwyn discussions it was generally agreed that mainly long-term debt should be cancelled, especially such part of it as was tax free.[4] Mr. Keynes particularly emphasized the economy of keeping a large part of the debt in floating form so long as the long-term rate of interest could not be reduced.

[1] Cf. his evidence before the Colwyn Committee.

[2] Cf. above, chs xxiii and xxiv.

[3] Cf. his evidence before the Colwyn Committee.

[4] On the other hand, the Treasury was still apprehensive of the volume of floating debt, because of the unpredictable budget charge to which it gave rise.

As to further policy there was no little confusion and difference of opinion. The economists, for whom the reduction of direct taxation was the main justification of a levy, urged that the maximum relief should be applied to income tax. But they were by no means precise as to whether the pre-levy active sinking-fund policy should be continued or reversed. Since economists (as distinct from financial interests) did not expect the levy to be seriously deflationary, the idea of reducing the sinking fund in compensation did not suggest itself. To this attitude Dr. Dalton was an exception. He regarded it as one of the chief advantages of a levy that it would enable the sinking fund to be drastically reduced or even abolished. The majority of Labour supporters, however, took the view that the burden of the debt would still be menacing, and should be further reduced. Many held that the budget saving should mainly be applied to the expansion of the social services. If tax rates were to be reduced at all it should only be indirect taxes. Since if the levy had been imposed it would mainly have been on social and political grounds, it is thus very likely that it would have been impossible to apply anything like the whole saving to the reduction of income tax.

The financial opponents of the general levy were particularly apprehensive of the contraction of credit which might ensue, both through psychological reactions and by the destruction of collateral embodied in the debt redeemed.[1] The importance of this had probably not been fully appreciated by Labour leaders, although on the other hand some of the claims of financial interests were quite fantastic. We shall have to examine this point at a later stage. Two other related points on which discussion was unsatisfactory were the effect of the levy on the foreign exchanges and on the internal rate of interest. In the circumstances of the twenties there was a considerable danger both of the withdrawal of foreign balances and of a flight of British capital as the result of the announcement of a levy. The main discussion of the exchange situation, however, centred round the effect on British credit abroad. Although this seems strange since there was at the moment no question whatever of the renewal of foreign loans, so far as it was not merely the after effect of difficulties experienced during the war, it is explicable by the vital necessity of retaining foreign balances for the stability of the gold standard.

[1] Cf. especially the evidence of Mr. W. W. Paine before the Colwyn Committee.

Although the mere reduction of the volume of gilt-edged debt outstanding must have had some effect in lowering the rate of interest, it was generally concluded that the levy would at best have but little effect on interest rates as a whole. The Select Committee had indeed concluded that in the circumstances of 1920 a levy would be effective in reducing interest rates. They anticipated that the reduction of the Treasury bill issue would be sufficient to move the short-term rate and that this would react quickly on other rates. Judging by the enormous volume of industrial borrowing at the high rates of 1919–20, the reduction of long-term rates was not in any case viewed as a matter of urgency. In the Colwyn discussions many witnesses emphasized the difficulties which would arise because levy-payers would be forced to sell securities before the redemption of debt could take place, and it was realized that this was more likely to lead to a widening of the gap between gilt-edged and other rates than to any general reduction. Mr. Keynes suggested that the reduction in the debt would call forth a flood of municipal and other trustee borrowers who would immediately force even the gilt-edged rate up again. Dr. Dalton and the Labour leaders, on the other hand, looked forward to the reduction of interest rates as one of the leading advantages of the levy. The balance of probability, however, seems to be on the other side.

There was a similar difference of opinion as to the effectiveness of methods of control and of the tools available for counteracting any undesirable secondary effects of the levy. In contrast to the Select Committee, Mr. Keynes was extremely doubtful of the power of the Treasury to reduce British interest levels below the world level. This was, of course, mainly due to the re-establishment of the gold standard. More serious differences were revealed when Professor Pigou doubted the manageability of a paper standard, but maintained that under a gold standard 'any deflation there might be would be quickly corrected by the familiar mechanism'. Dr. Dalton more plausibly considered that it would be easier to counteract deflation by monetary policy under a paper standard. These differences illustrate the uncertainty which prevailed concerning the monetary situation in 1925. Dr. Dalton appears to have been the only Colwyn witness to stress the importance of timing the levy so as to coincide with an industrial upswing. The Select Committee and its witnesses were so con-

vinced of the necessity for deflation in the interest of monetary policy that they devoted no thought to the matter.

It is not surprising that the Colwyn Committee made little progress in their investigations of the longer-term effects of a levy on saving and enterprise. Other parts of their work reveal a considerable confusion on fundamentals, even in relation to the simpler problem of income tax.[1] It must be remembered that they were writing before the important theoretical developments which have done so much to clear up the relation between saving and investment, and between the rate of interest and enterprise. At the same time it was already somewhat of an anachronism to view the problem as essentially one of the direct transfer of the savings of private individuals to real investment, as was implicit in the greater part of their analysis. They were prepared to recognize that a levy could have little direct effect on investment out of company reserves, but they considered the psychological aspect of much greater importance. As there was little direct evidence that a levy would cause people to save less, they concluded that there was no need to anticipate any contraction in this respect.

As a final result of their deliberations, the Majority of the Colwyn Committee returned a decisive negative to the idea of a capital levy. They based their judgement on conditions as they saw them in 1926–7. That is to say, they did not consider the fall in prices which had taken place since 1921 implied such an increase in the debt burden that the original investors had been grossly overpaid, nor that consequently a levy was urgent on grounds of equity. Nor did they anticipate any further great fall in prices in the immediate future such as would cause them to reverse their judgement on this matter. They did not foresee—and could hardly be expected to—the abandonment of the gold standard which within five years enabled all interest rates to be effectively lowered. They did not therefore look to any great saving from conversion. Had they foreseen that a far greater saving in debt service would be achieved by this means than seemed likely to result from a levy,[2] their negative verdict would have been

[1] Cf. comments on the evidence of Dr. Coates, and articles in the *Economic Journal*, 1927, particularly D. H. Robertson, *The Colwyn Committee, the Income Tax, and the Price Level.*

[2] Between 1928 and 1934 the debt service was reduced by about £100 millions. This was mainly due to the fall in long- and short-term rates as a result of the conversions.

even more emphatic. Although the possibility of conversion is not strictly relevant to the practicability of a levy, in this instance it clearly achieved the end which mainly justified the experiment in the eyes of its economic supporters—the reduction of the debt service to manageable proportions.

The Minority, on the other hand, considered that the price-fall which had already taken place amply justified the levy on grounds of equity. Basing their contention on a Note by the Treasury,[1] they stated that 'over two-thirds of the Debt was raised when the value of money was less than at March 1925'. The conclusion that the debt holders were grossly overpaid has been so widely accepted since the time of the Colwyn discussions that it is worth examining its validity. It is based on the assumption that debt is 'raised' at the time when it is funded (converted into medium or long term securities); but this is a very misleading way of looking at the matter. In fact the saving which is embodied in the debt must have taken place long before the time of funding. Indeed, a large proportion of the funding was done in 1919–20, when the war was over. If we look, not at the dates when the debt was funded, but at the dates when it was originally borrowed (which brings us much nearer the truth), we get a very different picture.

British War Borrowing

	New Borrowing (millions)	*Value in terms of 1925 prices* (millions)
1914–15	£450	£720
1915–16	£570	£830
1916–17	£1,540	£1,800
1917–18	£1,210	£1,210
1918–19	£1,250	£1,060
1919–20	£500	£410
	£5,520	£6,030

The total real value of the war debt turns out to be rather *less* in 1925 than it was when it was originally borrowed.[2] With the further fall in prices which took place in later years, the real value was of course raised beyond this figure; but it did not stay much above it for a long time before the interest was reduced by the conversions of 1932–4. Taking the period 1919–39 as a whole, it

[1] *Colwyn Report*, Appendix XXV.
[2] Real value is here calculated by the Cost of Living Index.

is hard to maintain that the original lenders received, on the average, much more or less than their bond.

In so far as monetary technique in the twenties was unprepared to deal with the shocks of a levy the adverse verdict of the Majority was understandable, if not inevitable. Yet the economic case for a levy at that time was better than was generally realized. To this point we shall have to return later, when examining the practicability of a levy in the respective circumstances of the twenties and the forties.[1] The supporters of a levy as represented in the Minority Report continued to advocate a levy, both on general social grounds, and because of their apprehension of the extent to which the debt burden would be still further increased by falling prices. The continued price fall in the next few years did in fact give rise to some recrudescence of the popularity of the levy idea, even outside the ranks of the Labour party. While security prices were rising, other prices falling, and the gold standard barred the way to a substantial conversion, there was indeed almost as substantial an economic case for the levy as there had ever been. But these conditions passed away before discussion had attained anything like its former proportions.

The general impression left on the public by the levy discussions was probably that the practicability of a levy had been established, but that no very suitable moment for its application had been found—nor any complete agreement as to its terms. Nevertheless, the principle was one which might prove useful on another occasion. It is therefore very desirable to examine what evidence there is as to the practicability—in the broadest sense—of introducing a capital levy into the British fiscal system.

[1] See below, p. 285.

CHAPTER XXVIII

THE PRACTICABILITY OF A CAPITAL LEVY IN GREAT BRITAIN

THE Select Committee on War Wealth gave it as their opinion that a capital levy was practicable in the limited sense that 'it would be possible to carry out the examination of contributors' returns in an effective and impartial manner, and that the cost of collecting the tax would be small in relation to the yield'. This was hardly more than a minimum definition of administrative practicability. A more exacting criterion was suggested by Stamp.[1] If, he says, with good administration, not more than 70–80 per cent. of the yield can be collected, or if unintentional inequalities between individuals are introduced, then a tax should not be considered practicable. These standards are certainly not always fulfilled even in the normal fiscal systems of many foreign countries, but we have been generally successful in maintaining them in this country, and should surely hesitate very decidedly before agreeing to depart from them.

Continental experience suggests that the two essentials for the successful operation of a capital levy are: first, that it should be possible to carry out the valuation with speed as well as with equity; and second, that it should be possible to collect the revenue quickly. These conditions have wide implications. In the first place they postulate a high degree of psychological acceptance of the levy by those liable to it. Nothing delays valuation and ruins the standard of collection so much as the evasions and deliberate obstruction of disgruntled contributors. Secondly, they imply the provision of methods of payment which will not have untoward financial repercussions. Fiscal bankrupts are no good to the State and they injure other people. Thirdly, they imply that the levy must be imposed at a time when price movements will not upset the whole mechanism of valuation and collection before it is completed. If these conditions are fulfilled, the levy operation has a reasonable chance of success. But will it therefore be desirable? We must also be assured that it will not have unfortunate financial and economic effects, or if it does, that the means exist of counteracting them. Finally, a levy is always disturbing, very

[1] Cf. *Current Problems in Finance and Government*, p. 229.

disturbing. We want to be convinced that it is worth while in the sense that the problem it is supposed to solve really requires an *ad hoc* solution, and that no less disturbing one can be found. Without these further conditions a levy cannot be regarded as really desirable from the economic point of view.

The investigators of the twenties, and especially the Inland Revenue, laid very great emphasis on the necessity for psychological acceptance as a prerequisite for a levy. All their estimates were accompanied by the proviso that in the absence of general acceptance they must be regarded as worthless. It is clear that the position on this point was not very satisfactory. Mr. Keynes went so far as to say in his Colwyn evidence that a levy would 'insult a set of very strong irrational feelings in men'. Nor would they have been entirely irrational. The heavy increase in the weight of super-tax and death duties since 1914 implied that the wealthier classes were already being made to revise more rapidly than ever before their ideas of a reasonable rate of redistribution of wealth.

The danger which the Inland Revenue feared was a very real one. Apart from internal valuation and collection difficulties, there was no means of preventing capital flight, and no means of preventing the export of capital, if it took place, from affecting the exchanges. In 1920 the state of the exchanges was already a matter of concern. The restoration of the gold standard had been adopted as a definite policy. In 1925–7 the retention of capital was absolutely vital. In 1920 the support given by financial experts to the idea of an increment levy might have been sufficient to secure its acceptance by financial and business interests, especially as the idea of a levy on war wealth was very much less repugnant, and the operation would in any case have been a small one. There was very much less hope of wide acceptance of a general levy.[1] More than one of the Colwyn witnesses hinted at the probability of organized resistance on the part of the banks.

In almost every one of these respects the practicability of a capital levy is now very substantially greater. We no longer need to rely on the import of foreign capital to maintain our exchanges,

[1] The chief safeguard against non-acceptance was held to be a guarantee against repetition. A number of ingenious methods of doing this were suggested, such as stamping scrip with a certificate of twenty years' exemption. It was evident that no guarantee could be absolute and that the matter was at bottom a political question. Even if the guarantee had been believed in, it is hard to see that it would greatly have increased the acceptability of the levy.

and in any case the mechanism of the Exchange Account is available to mitigate the effect of withdrawals. Much more important, a workable method of exchange control has at last been evolved, which is sufficiently comprehensive to make large-scale flight impossible. Again, the control of the Monetary Authorities over the banking system is both technically and psychologically very much more complete than it was in the twenties. These facts imply that a levy could be successfully carried through at a lower level of acceptability than in the twenties. The level of acceptance, however, so far from being lower would probably be substantially higher. It is not without significance that the Chancellor of the Exchequer dropped a hint of a levy after the war in the first war budget, although clearly he had in mind only the increment levy which had received the blessing of the Select Committee.

In view of the vital need for speed, it was generally agreed in discussion that assessments should be made on taxpayers' own returns in the first instance, with heavy penalties if they were directly misleading. This method was suggested to the Select Committee by the Inland Revenue. The returns, except those where the property was obviously under £5,000, would all subsequently have had to be checked over. Not unnaturally the Inland Revenue viewed the process of valuation as a 'task of the first magnitude', and one that would take at least two and a half years to complete, even if as fully trained and adequate a staff as that commonly employed on death duties were available. The difference in scale of the task can be realized when it is remembered that less than 100,000 death-duty returns have to be checked in a normal year. It will be recalled that the number of contributors to the increment levy was estimated at 340,000, and that all these properties required double valuation. The problem for the increment levy was thus considerably more serious than for the 500,000 potential payers of the general levy. It is difficult to see where an adequate staff could have been procured from, particularly within a short period after the war.[1]

The type of valuation which the Inland Revenue had in mind was 'essentially that commonly used for the estate duty'. They judged that probably the whole of land and farming capital would

[1] In the last war the Inland Revenue lost 3,000 staff to the services. They must have been short-handed for a considerable period after the close of hostilities, cf. Stamp, *Taxation during the War*, p. 109.

have to be valued *ad hoc*, and every private and semi-private business valued as a going concern. Many supporters of the levy were prepared to adopt a more summary method of checking returns than the commissioners suggested. Thus Professor Pigou, writing in 1918, reckoned that 70 per cent. of wealth was in the form of stocks and funds, cash, mortgages and insurance policies, for which quoted values could be taken. For a further 16 per cent., consisting of land, houses, business premises, &c., he would have been prepared to adopt the income-tax valuation. The remaining 13 per cent. (or as he thought more probably 20 per cent.) he suggested might be left until the property next passed at death.

For an increment levy which is more concerned to value a change than a total, it might be legitimate to adopt methods which would not be appropriate for a general levy.[1] Recent research suggests, however, that the problem would have been more difficult than Professor Pigou allowed for even at that time.[2] Income-tax valuations of land are notoriously inadequate, and their use for buildings is somewhat questionable. To postpone the assessment of certain forms of property for various periods, depending on the deaths of the owners, would not only have been unjust between individuals, but would have considerably reduced the yield of the levy, a result which could be ill afforded. Further, even where prices are quoted it is not necessarily easy to select the most equitable value. This would have been specially true in the stock-exchange boom and slump of 1919–21, when there was a most striking want of synchronization in the high and low values of different securities. If valuation had been carried out in July 1919 as suggested, the more solid types of security would, in company with gilt-edged, have already passed their post-war peak, the majority of industrials would just have reached theirs, but the more speculative lines and the industries which were to prove the striking post-war successes had still a good way to climb to their peak. It would not have been easy to choose a moment (or even a period over which to average values) which would at the same time have been reasonably equitable between one type of holding and another, in line with values when the levy fell to be paid, but not so near as to be affected by

[1] It will be recalled, however, that Professor Pigou was recommending a general levy.

[2] Cf. Daniels and Campion, *The Distribution of the National Capital*, and H. Campion, *Public and Private Property*.

apprehension of the announcement of the levy. The difficulty of changing prices was the rock on which most continental levies foundered. Even in the milder British conditions it would have made the increment levy very hard to work.

Obviously the difficulty of the general problem of valuation depends on the standard of thoroughness aimed at. The Select Committee expressly put to the Inland Revenue officials the suggestion that values might be obtained by capitalizing incomes, as was commonly done abroad. They replied categorically that 'To call the result a capital valuation would be an abuse of language'. It is probable that the country would not have been satisfied with worse methods and lower standards than those adopted for death duties. In that case the only possibility would have been to make provisional valuations on individuals' returns, and sternly to resist the temptation to allow adjustments even in cases of comparative hardship. It must be noted, however, that to levy the tax according to this device is only one degree less awkward than carrying through the official valuation prior to assessment. The army of professional valuers whom the State does not need to employ must nevertheless be at the disposal of the hundreds of thousands of conscientious levy-payers who have to make their returns.

Apart from the notorious difficulties of valuing private businesses and companies whose shares are not regularly quoted, the biggest problem[1] in the detail of valuation is concerned with settled property. The memoranda of the Inland Revenue supplied to the Select Committee fully emphasized the difficulty of valuing correctly the separate interests, particularly of life tenants and remainder-men. For the increment levy the problem was not of first importance, since the amount of settled property which had increased in value was necessarily small, owing to the downward course of trustee securities during the war. For the general levy, on the other hand, the problem was of considerable importance. It was estimated that one-sixth of the property liable to assessment was settled. It was therefore essential to find a simple method of dealing with the problem, which would be at the same time reasonably equitable. Various short-cut methods were put forward.

[1] If we omit the tiresome and quantitatively unimportant problem of valuing such things as jewellery and old masters. On the continent various devices were invented to deal with these, of which the most sensible seems to have been to exempt them from the levy if they were made accessible to the public.

Professor Pigou again thought that the simplest plan would be to postpone assessment until a convenient moment—when the settlement fell in. Another suggestion was that instalment paying might be allowed, with (in this case only) provision for revaluation in special cases of hardship. Both these methods would have delayed collection and added to the complication of the levy.

Ultimately the Inland Revenue propounded to the Colwyn Committee a solution which was both comparatively simple and not grossly inequitable. This was to abandon the idea of treating the different interests separately, and (following the estate duty procedure) to assess the whole value of the settled property together, and pay the tax out of the settled fund. The rate of tax for the life tenants would then be determined by adding together their free and settled wealth and assessing it as a whole.

It would seem from the Inland Revenue's memoranda that there were no specific valuation problems which could not be surmounted or by-passed by some device giving a solution of reasonable equity. For different types of levy different difficulties would be particularly urgent. In every case, however, the effect of the devices which had to be adopted would be more serious for the general levy, just because errors would be magnified in the larger tax. In any type of levy, as contrasted with death duties, one major difficulty is that taxpayers survive to argue about valuations and to observe the development of inequalities.

There is nothing to suggest that valuation difficulties have decreased with the course of time, although it may be argued that the greater experience which the Inland Revenue has gained in preventing evasion, on account of the enormous increase in importance of surtax and death duties in the fiscal system, would enable them to tackle the problem more efficiently than they could have done in the twenties. In this sense, too, the levy has probably become slightly more practicable. But greater skill does not necessarily mean that the checking process could be carried through much more quickly, and as we have seen speed is the crux of the problem. The broad conclusion seems inevitable that the adoption of a capital levy implies acquiescence in a lower degree of equity between similarly placed individuals than is usual in the British fiscal system. But this does not necessarily condemn it if other considerations are greatly in its favour.

A question of importance, both for the administrative practic-

ability of a levy and for its subsequent effects, is concerned with the methods of payment permitted. The simplest payment situation is clearly one where levy-payers hold sufficient amounts of war loan to discharge their levy obligations out of their debt holdings. Next in simplicity is the situation in which only readily marketable securities have to be sold in order to pay the levy. These ideal situations are hardly likely to be realized in practice, and in every other case the transfer problem is likely to be a serious stumbling-block at least for some categories of levy-payers.

In the absence of statistics of personal holdings of war loan it was impossible to estimate closely the proportion of levy which might have been paid directly in war loan. On the basis of death-duty figures the Inland Revenue estimated that it would vary between 50 and 75 per cent., according to the size of the levy. The larger the yield sought the smaller the proportion which could have been discharged in this medium. (Of course it does not necessarily follow that levy-payers would have been willing to sacrifice a large part of their holdings of war loan unless they had been offered some special inducement.) Death-duty figures suggest that gilt-edged securities are held more nearly proportionately to wealth than other types of liquid asset. While this may not be true for the community as a whole, in so far as it is so, it suggests that a smaller part of a highly progressive levy could be discharged in this way than would be the case if the levy were less progressive. On the other hand, death-duty figures almost certainly exaggerate the holding of liquid assets in general by small capitalists, and so tend to overstate the ease with which the smaller contributions could be collected. Thus the more progressive the levy the less trouble would be caused by the illiquidity of assets, but the smaller the proportion which would be likely to be discharged in war loan.[1] In view of the probably increased importance of small subscriptions in the new war debt, the relative ease of raising a proportional levy would probably be increased—subject to the limitation imposed by the lack of liquid assets.

It follows from the distribution of security holdings that there is a good case for extending the list of approved securities as far

[1] Apart from the effect of any special measures to induce payment in war loan. Continental experience suggests that such measures need to be used with caution, especially if there is already a tendency for interest rates to rise; see above, esp. p. 232.

as possible if a steeply progressive levy is contemplated. In the twenties many supporters of the levy would have been prepared to let it include industrial debentures and even reliable preference shares,[1] but this would have led to obvious difficulties. The Colwyn Committee did not express an independent opinion on this point. Since then the stock exchange collapse of 1929 has made it plain that not even confining the list to the trustee class could ensure the government against heavy loss if the securities had to be held for any length of time. In view of the well-known caution of the Treasury it is not likely in any case that the list would have been long.

In the twenties it would have been hardly conceivable for the Treasury to hold a miscellaneous portfolio of approved securities, even for a short period. There is little doubt that there would have occurred a serious widening of the difference in yield between gilt-edged and industrial securities, merely as a result of the payment of the levy, and apart from panic sales or other psychological reactions. Immediately after a war, when an exceptional amount of borrowing is likely to be required to make good war losses and depreciation, this is a serious consideration. It is possible that these difficulties might be less serious in the future. It is not inconceivable that the experience which the Treasury has recently gained in managing the investments of the Departments might make it willing to accept a longer list of approved securities, since it would have the facilities for getting rid of them gradually without unduly depressing their prices. In addition, the improvement in monetary technique might enable the authorities to push the gilt-edged interest rate still lower and thus secure a reasonable rate for new borrowing, even if the gap between government and industrial yields did tend to widen.

Whatever types of securities were made available for levy payment, there would still have remained at least two classes of levy-payers for whom special methods of payment would have to have been arranged, namely landowners, and the proprietors of small businesses, where the greater part of the owners' capital was invested in the concern.

The Colwyn Committee received some evidence which made it possible to make a rough estimate of the extent of the need for special facilities for small manufacturing firms, in the shape of a

[1] As suggested by Lord Arnold in the *Economic Journal*, 1918.

sample taken by the Inland Revenue in 1919 and examined again in 1923. This showed (for 216 firms) aggregate capital, its distribution between business and private assets, and the extent of indebtedness to the bank. The sample was considered to be fully representative of its class, but did not include trading firms. It appeared that only a small proportion of the firms[1] were indebted to the bank in both good and bad years, and that even they held a reserve of private assets equal on the average to more than a third of total assets. Almost half the sample were in a position of comfortable liquidity in both years, with a reserve of private assets equal to more than half total capital. This suggests that the problem of the small firm is not so serious as it is often thought to be, although agricultural and trading businesses would probably be in a more difficult position than the industrial firms examined. The seriousness of this difficulty depends on the degree of progression of the levy. For a proportional levy it would certainly be considerable. On the other hand, the more generous allowance for small firms in E.P.T. gives some hope that they may end up the war in a more comfortable position than their predecessors in 1919. For hard cases it would no doubt be necessary to arrange additional credit facilities with the banks, and probably also to countenance a (strictly limited) amount of instalment payment. Even these reliefs would tend to leave an aftermath of regular obligations fixed irrespective of the volume of profits, and consequently a greater burden on enterprise than a corresponding income tax.

The small firm needs its liquid assets not merely for paying the levy but for use as collateral. The whole question of the destruction of collateral as a result of the redemption of debt is one of considerable importance for the subsequent economic effects of a levy. The Select Committee did not devote much attention to the question, since for an increment levy it would not be of much significance, particularly if mainly floating debt were cancelled. Among the Colwyn witnesses there were wide differences of opinion as to the probable restriction of credit which might ensue from the redemption of £3,000 millions of war loan. Some opponents of the levy actually claimed that it would exceed the total nominal amount of the levy.[2] Stamp devoted considerable attention to the question,[3] and was not likely to take an over-

[1] Cf. *Colwyn Report*, p. 230. [2] Cf. especially the evidence of Mr. Paine.
[3] Cf. *Current Problems in Finance and Government*, p. 246.

optimistic view of the prospects. His guess was that the volume of personal holdings of war debt subject to the levy might be about £1,000 millions, and of these some £400 millions might at any moment be in use as a credit basis. He pointed out, however, that the destruction of collateral is more serious than its absolute amount would suggest, since government debt is the most eligible of all forms of collateral. There is not sufficient data to make a reliable estimate on this point. Even if the amount of scrip pledged at any moment were known, it would hardly be possible to estimate the credit based upon it, and even this would be a poor guide to the aggregate use of collateral over a period. It is possible that with the gradual decline of the industrial use of bank advances the destruction of eligible collateral might now be less serious than it would have been in the twenties. But at the end of the war the need for it would certainly be greater than in normal times, so that its destruction might well have a deflationary effect. This could, however, be counteracted.

In the discussions of the twenties very little attention was paid to the importance of timing a levy so that its depressing effects should be opposed to the general economic movement and provide a natural counterpoise. Yet timing is one of the most important points in connexion with a levy. In the case of an increment levy there is no doubt whatever as to the correct moment for launching: it should be in time to control the post-war boom. But in practice it must always be extremely difficult to bring this off. If the monetary authorities lose control of the situation, so far from the levy restraining the boom, the boom will carry the levy along with it. This happened more than once on the Continent. If, on the other hand, the levy is delayed beyond the boom, it tends to accelerate the sagging tendency of prices, and valuations become so unfair and onerous that it is necessary to revise them downwards, thus discriminating between early and late payers of the levy. In this country, even if a levy had been imposed not later than 1920 on 1919 valuations, it must have put many payers into an awkward position. There is always likely to be only a small margin for the timing of an increment levy. This is the more unfortunate since it requires more administrative work than a general levy. In the disorganized conditions which must be expected immediately after a war, this would take more time than usual.

For a general levy, imposed in a period of relative stability,

there is considerably more margin in timing, but if the levy is a big operation it is still very desirable to launch it on the tide of an upswing; and the right sort of economic conditions may not present themselves. As it happens, Dr. Dalton, who was one of the few Colwyn witnesses to pay attention to the problem of timing, made a remarkably good shot in suggesting that if the preparations were set going immediately, the levy would fall appropriately—that is in the years 1928 and 1929. Generally speaking, it is hard to persuade the public that an upswing is really in motion, and harder still to impose a measure which jeopardizes its development. If the timing of the levy proves unfortunate the government must be well prepared with measures to counteract its depressing effects.

Apart from the inherent deflationary tendencies of a debt redemption levy, there are thus several directions in which it may have a depressing effect. Most of these, although secondary, are fairly short period. It is therefore very desirable to take counteracting measures promptly before deflation can get hold. Counteraction may be either purely financial—by means of open market operations or other methods of forcing down interest rates, or it may be combined with direct economic action such as the expansion of public investment.[1] In both these directions it will probably be agreed there is considerably more chance of success than there would have been twenty years ago. On the one hand, it is just for counteracting this sort of general depression that the new market control technique is most appropriate. On the other, public investment on a considerable scale has already been carried out successfully, and there is wide scope for further development.

It thus appears to emerge that while a levy must always be open to objection because it lowers the standard of fiscal equity, in several respects its administrative practicability has probably somewhat increased since the twenties. In addition, owing to the development of monetary technique, there is available a larger box of tools for counteracting the ensuing disturbance. We must now turn to consider whether, and in what circumstances, a levy would be worth while in view of its longer run fiscal and economic effects.

[1] It might appear that the expansion in the Public Debt which this would cause would undo the effect of the levy. But the effect on enterprise would of course be entirely different.

CHAPTER XXIX

THE NET YIELD OF A LEVY

We have seen that the most convincing argument adduced against the imposition of a capital levy in Great Britain after the last war was based upon the loss of receipts from other taxes, the reduction in taxable capacity which would result from the levy. The imposition of a levy would reduce taxable incomes, and thus reduce the yield of income tax and surtax; it would directly reduce the value of private estates, and consequently the yield of death duties. When these losses were allowed for, the net annual saving to the government was so greatly reduced that the levy became a much less attractive proposition; from the standpoint of the Exchequer, it would clearly not have been worth the trouble it would have caused. Is this still true? Is it still likely to be true after the end of the present war? These are the questions we have now to consider.

It is clear, to begin with, that the question need only be discussed with reference to a general levy. The net yield of an increment levy (a levy on war wealth) must of necessity be much smaller than that which could be reached by a general levy; if a general levy is not worth while fiscally, an increment levy (with its higher costs of administration) would be even less worth while. But of course the serious case for an increment levy is based upon grounds of equity, not of yield; so it may be less affected in practice by the sorts of considerations examined in this chapter.

Of all the calculations of the net yield of a levy made after the last war, the most explicit is that of Lord Stamp.[1] A later estimate was made by the Inland Revenue for the Colwyn Committee,[2] but the methods used were less fully stated. Consequently it will be convenient to base most of our discussion upon Stamp's calculation. Its broad lines were as follows.

The type of levy under discussion was more or less that put forward by the Labour Party;[3] this was a steeply progressive levy, the rate on the largest estates rising to about 60 per cent. When the gross receipts from such a levy were calculated for the Colwyn

[1] *Current Problems of Finance and Government* (1923), pp. 250–70.

[2] *Committee on National Debt and Taxation*, Appendix to Report, pp 169–72.

[3] The scale is given on p 9 of the same Appendix.

Committee, they came out to approximately £2,500 millions. Stamp does not give an estimate himself, but his results are stated as they would apply to a levy of £3,000 millions; this is even more drastic than the Labour party scheme, but a similar system of progression was presumably assumed.

The gross annual saving in interest resulting from a levy depends upon the rate or rates of interest on the loan to be repaid. The rate of interest on long-term debt was taken at 5 per cent. in the twenties, so that if only long-term debt had been redeemed the gross saving on a £3,000 million levy would have been £150 millions. If any floating debt was included, then (at any date after 1921) the yield would have been lower. Following Dalton, Stamp put the gross saving at £142 millions.

The loss of receipts from income tax could be easily calculated. The total loss of taxable income as a result of the levy would be equal to the gross saving in interest payments. Although the loss of income would be distributed among the taxpayers in a very special manner, due to the sales of property which would be needed in order for the levy to be paid, this would not matter so far as income tax was concerned. Income tax is charged at a flat standard rate (apart from allowances, which are unlikely to be important in this connexion); consequently the loss on income tax can be calculated by applying the standard rate of income tax to the gross savings. Stamp thus put the income tax loss at £32 millions.

Supertax is more difficult. Here it is necessary to consider what rate of supertax is payable on each income, before and after levy, and that depends upon the size of the income. Stamp assumed, which seems fairly reasonable, that the incomes in question were purely unearned incomes; so that the income before levy could be calculated by applying a normal rate of return on capital to the capital levied. He also assumed, which seems more doubtful, that the income after levy could be calculated by applying the same normal yield to the post-levy capital; this is not a very safe procedure, since the normal yield on capital is higher than the yield on the cancelled war loan; if the levy were entirely paid out of war loan, the loss of income would be distinctly less than a normal yield on capital. It is, however, not to be supposed that the levy would be entirely paid out of war loan; although the cancelled war loan and nothing else is the loss which has fallen upon the capitalist class as a whole, there will be a certain amount of selling of

industrial securities from the richer capitalists to the poorer, since the richer capitalists have to pay higher rates of levy. But the richer capitalists also pay higher rates of supertax, so that the fact that their incomes will fall by more than the ordinary yield on gilt-edged is very significant; but they will still fall not so much as by the sums which would be got by applying the ordinary rate of income on capital to the levy payable. An accurate computation of supertax loss would probably have to allow for the loss of income as a result of the levy bearing a smaller proportion to the capital lost than the proportion which income as a whole bears to capital as a whole. Stamp does not appear to have taken account of this refinement, but he leaves a wide margin for error in his supertax estimate. The loss of revenue from supertax was put at £32½–39 millions.

The statistical *tour de force* was the calculation of the loss from death duties. The great statistician did not content himself with any rough calculation on the basis of current death-duty liabilities, but worked out the probable duration of life for the owners of estates of various sizes, and thence the probable receipts from death duties, in the absence of a levy, and with a levy, this year, next year, and so on into the future. Nor did he allow only for the deceases of existing owners; the 'second devolution' on the deceases of their successors was also taken into account. The present value of this series of losses was then calculated, and it was reduced to an annual charge—£25 millions. Assuming a proportional loss of succession duties, the total loss of revenue from death duties came to £28 millions.

Thus against a gross saving of £142 millions, there was estimated to be a total loss of revenue equal to £92–100 millions. The net saving would be no more than £42–50 millions per annum.

When the Inland Revenue remade the calculation for the Colwyn Committee, they calculated that a levy of £2,500 millions on the Labour party scale would bring in a net saving of £48 millions per annum; a levy of £3,000 millions, obtained by increasing this scale by 20 per cent. throughout, would give a net saving of nearly £58 millions.[1] These figures are more generous than Stamp's, but they are of the same order.

Under the conditions of the nineteen-twenties, a net saving of

[1] *Committee on National Debt and Taxation, Report*, p. 254, and Appendix, pp. 171–2.

about £50 millions a year—say 7 per cent. of the budget—did not seem sufficiently attractive to warrant the disturbance which would be produced by a levy. It is not certain that this would still be the case in the future. In view of the level which taxation is likely to reach after the present war (if only on account of the real loss in national capital and the compensatory debt which will stand for that loss in the government's accounts)[1] a net saving of £50 millions a year, or what corresponds to £50 millions a year in post-war money, may seem distinctly more worth having than it did fifteen years ago. But will a levy of this sort, carried out in the future, be even as productive as a levy would have been in 1923 or 1927? There are certain reasons which make it appear very doubtful.

In the first place, interest rates are a good deal lower than they were in the nineteen-twenties, and so long as the government succeeds in maintaining its present degree of control over the financial system, there is no reason why they should not remain low. This must reduce the gross saving from a levy. In the second place, rates of direct taxation are even higher than they were then. This must increase the loss of revenue proportionately to the gross savings.

There is of course no reason to suppose that the ferocious rates of direct taxation, which have been imposed during the war, must persist without abatement when the war is over. But even if we neglect the increases which have taken place since the war began, and also the increases which took place to pay for rearmament before the war started, it is still true that the basic rates of death duties, in particular, are higher than they were when the earlier calculations were made. It is not likely that we shall go back to a level of direct taxation which is lower than that in force (say) in 1936; even in 1936 there was already an important rise in death duties (1930) to take into account.

Since it is impossible to make calculations about a post-war situation not yet conceivable save in barest outline, the effect of these two changes can best be estimated by making a rough calculation of the probable yield of a capital levy in the nineteen-thirties, after interest rates had fallen and death duties had been raised. Comparison with the earlier estimates will at least show us the effects of these changes, and will give us some fairly sure ground from which to hazard a guess about the future.

[1] See above, ch. iii.

For the purpose of this calculation we selected the year 1936. In 1936 the effect of the rearmament on the tax structure had not yet begun, though the effect of the fall in interest rates was fully apparent. The main lines of Stamp's analysis were followed, but it was clearly not worth while to proceed to the same degree of refinement over a purely hypothetical calculation as it would be for the case of a levy which might actually have been imposed. The technique was accordingly simplified in several respects.

First of all, in order to estimate the total value of all estates in each class from the published figures of those becoming liable to death duties, we simply used a 'multiplier' of 30 throughout, instead of going through all the complications of age-distributions and mortality tables which would have been necessary for a closer estimate. Secondly, we paid no attention to the 'second devolution' of death duties, and consequently to these simplifications, we neglected the distribution of the loss in death duties over time. From a scrutiny of Stamp's procedure it appeared that none of these simplifications would make so very much difference; and in any case, they would all tend to make our estimate come out higher than the true figure for the net yield of the levy,[1] so that it would not lose its usefulness as a maximum limit.

Taking as our basis the average capital assessed to death duties during the years 1934–6 (this seemed safer than to take the year 1936 alone), we got an estimate for the total capital which might be subject to levy as about £11,800 millions. Upon this total we imposed a levy according to the Labour party scale previously referred to; this gave us a total receipt from the levy of £2,950 millions as against the £2,500 millions of the Colwyn estimate, and the £3,000 millions to which Stamp's figures were made to refer.

Assuming an average rate of interest on government debt at 3¼ per cent., the gross saving from a levy on this scale would be £97 millions per annum. From this gross saving there has to be deducted a loss in revenue under the three heads.

The loss in receipts from income tax can be calculated (following Stamp) by applying the standard rate of income tax to the gross savings. In 1936 the standard rate of income tax was 4*s.* 9*d.* in the £; so the loss in receipts from income tax comes out at £23 millions.

[1] The true multiplier is undoubtedly less than 30 for the case of the largest estates, so that these estates actually contribute more to death duties than our figures allow for.

Stamp does not say what was the representative yield on capital which he employed for his supertax computation, but he quotes another writer[1] who put it at 7 per cent. For the year 1936 a yield of 7 per cent. is clearly too high; it was probably too high even in 1923, at least with respect to the income lost as a result of the levy. Since it did not seem worth while to distinguish between the rate of yield on the capital lost and the rate of yield on the capital as a whole, for the purpose of a very rough calculation like this, we decided to put the representative yield at the conservatively low figure of 4½ per cent., and to proceed on the usual lines. This gave us a loss in receipts from surtax of £18 millions: a figure which was bound to be on the low side.

So far as the loss in death duties was concerned, we made the above-mentioned simplifications, but otherwise followed Stamp's procedure.

Calculating the death duties on the estates before and after levy, we got a loss in estate duties coming out at £30 millions. Assuming a proportional loss of succession duties (£4 millions), the final result was therefore as follows (Stamp's estimate and that of the Inland Revenue, all expressed so as to refer to a levy of about £3,000 millions, are put alongside for contrast):

Net Annual Yield of a £3,000 millions Levy[2]

(Millions of £'s)

	1923 (Stamp)	*1927 (Inland Revenue)*	*1936*
Gross saving in interest	142	150	97
Loss on income tax	31	28	23
Loss on surtax	31½–39½	29	18
Loss on death duties	28	36	34
Net saving	42–50	57	22

If a capital levy (on the scale under discussion) had been imposed in 1936, the maximum net saving to the budget which

[1] See above, p. 229.

[2] Since publishing the first edition of this book we have become impressed by the importance of the reduction in the yield of income taxation in later years which results from death duties, when the rates of both are high. It is probable that the consequential 'overlap' between loss on income taxes and loss on death duties is insufficiently allowed for in the above table, though it would make little practical difference to the result. (See correspondence with Mr. O. R. Hobson in *The Banker*, Nov.–Dec. 1941.)

could have resulted would thus have been something like £20 millions per annum, which was then about the yield of 5*d.* on the income tax. With higher rates of income taxation and death duties, the yield would of course be even lower.

Is this situation likely to be transformed in the future? It is unlikely to be altered very much. Suppose, for the sake of argument, that Britain finishes the present war with a national debt of £15–20,000 millions, a level of money incomes which settles down to 30–50 per cent. above 1936, and a total value of private property about double the value in 1936.[1] Then it is possible that the gross receipts from a levy on the scale discussed (and it should be remembered that it is not possible to have a much more drastic levy without making the scale less progressive) might be double the 1936 receipts—that is to say, about £6,000 millions. But the net saving would not be double the 1936 saving; for the rise in money incomes and in the money values of estates would increase the numbers of incomes and estates liable to the higher rates of surtax and death duties—inflation automatically makes the tax system more progressive, and although something might be done to correct this by adjustment of rates, the effect is unlikely in practice to be removed altogether. The net saving from a levy in these presumed post-war circumstances would still be no more than £30–40 millions, probably nearer the lower figure. But with money incomes running at a higher level, the yield from other taxes would also be increased; 5*d.* on the income tax would bring in £25–30 millions, or something like that. Plausible conditions can perhaps be imagined in which there would be rather more difference, but it is not very easy to do so. The only real chance of a progressive levy yielding much more (in proportion to the yield of other taxes) than it would have done in 1936 is for there to be a rise in the rates of interest on internal government debt; and that is an eventuality which ought never to be allowed to materialize to any important extent.

It must be emphasized that these calculations refer to a levy of the type usually discussed in England—a progressive levy imposed at much higher rates on large estates than on small ones. A considerably higher net yield could be secured if the levy were less steeply progressive; by stiffening up the rate of levy to 20 or 25 per

[1] In view of the analysis of war debt given in ch. iii above, it would appear that these figures are roughly consistent with one another.

cent. on the *small* estates it might be possible to get a net yield considerably larger than the figure we have arrived at—perhaps more than double. But a more nearly proportional levy is of course a much less attractive proposition socially and politically.

There is one further point which needs to be mentioned. Neither the Stamp estimate nor that made for the Colwyn Committee includes any allowance for the reduction in sinking fund which would probably have taken place as the result of the imposition of a levy in the nineteen-twenties. It is unlikely that in practice a debt of £4,000 millions would have been considered to need the same sinking fund as a debt of £7,000 millions; so that there would have been some relief to the budget from this source, as well as from the reduction in interest charges which was calculated. (As we saw in our earlier discussion, some adjustment of sinking funds would have been very desirable on economic grounds, for the sake of maintaining the balance between saving and investment.[1]) When this reduction in sinking-fund payments is taken into account, it would appear that the case for a levy in the nineteen-twenties was rather better than it appeared to be from the computations made at that time; nowadays—and probably for the future—not only is the net saving in interest so much reduced, but there can also be little expectation of any incidental gain on the side of sinking fund.

During the nineteen-twenties it was customary to appropriate considerable sums every year for the repayment of debt.[2] These sinking funds were not infrequently raided to meet budget deficits, but the Chancellor had to allow for them as part of the expenditure to be covered out of taxation. Since 1931 the general sinking fund has been abolished; although certain sums have in fact been allotted to debt repayment, out of budget surpluses or otherwise, in principle the Chancellor has not had to allow for any considerable amount of debt repayment when drawing up his budget. As we have seen, the attempt to repay war debt by the nibbling of a sinking fund has little to be said for it;[3] the new policy is not to be regretted. But it means that the net saving of interest charges as the result of a levy cannot expect any reinforcement from reduced sinking-fund allocations.

[1] See above, pp. 202–3.

[2] The sum allocated to 'new sinking fund' was as high as £65 millions in 1927.

[3] See above, p. 201.

CHAPTER XXX

THE FUTURE OF THE WAR DEBT

THE first year of the present war increased the national debt of Great Britain by about £1,500 millions; in the second year the increase took place at an even faster rate. What will be the consequences of this new debt? What can we plan to do about it? These are the questions which remain to be discussed in this last chapter.

It will be recalled that in our earlier discussions[1] we found that the form of the debt made a considerable difference to the burden of interest. Compensatory debt, which on balance merely offsets those assets of taxpayers which are used up or destroyed, gives rise to no additional taxable capacity which will help towards the interest charge. The same is true of External debt, which in addition has special difficulties of its own. But Internal debt which is subscribed out of savings does give rise to new taxable capacity. It automatically produces more revenue which goes to offset the interest burden to some extent. The extent to which it has this convenient result depends on the distribution of debt holdings. A much larger proportion of debt interest will return to the Exchequer as tax payments if the debt is held mainly by the wealthy or by the companies in which they hold investments, than if it is held by the less wealthy or by the institutions to which they confide their savings. Except in respect of external debt,[2] the burden of which depends mainly on American policy, it is already possible to draw some tentative conclusions, both as to the form of the new debt and as to its distribution.

In the first place it is extremely probable that the importance of compensatory debt will be greater in this war than it was in the war of 1914—remembering that we have used this term[3] to cover the whole of the debt which offsets loss of assets, whether or not compensation is given for the loss. In the present war, although the loss of life has so far been small, the loss of real capital seems likely

[1] See above, ch. III.

[2] One fact which is already important is perhaps worth noting. The Dominions are rapidly accumulating large balances against the Mother Country. This foreshadows a change in intra-imperial relations which may have important effects in the future.

[3] See above, p. 25.

to be more widespread than it was in 1914–18. The equipment of the fighting forces is very much greater than it used to be, and up to the present it is probable that it has been provided out of capital to a considerable extent. In addition, the destruction of industrial and domestic equipment through air raids is itself a reduction in future sources of income which may take some years to restore. If the State gives compensation for these private losses there is an extra interest charge without any increase in taxable capacity to help towards paying it. If it does not give compensation there is a loss in taxable capacity which partly offsets any increase in taxable capacity arising from the borrowing of savings.

In respect of the distribution of debt holdings also it seems likely that the budgetary problem will be more serious than last time, because the increase in taxable capacity will be in a form less convenient to the Chancellor. Broadly speaking, the last war was financed on the principle (at least to begin with) of allowing the war profiteer to have his fling, bribing him to invest heavily in war loan, and then taking back a good deal of the bribe by supertax and death duties over the next twenty years. In the present war, a very different principle has been employed from the start. Excess profits are to be confiscated, and the rates of direct taxation (particularly on the higher incomes) are sharply increased. As a result, the genuine savings of the wealthy invested in war loan are likely to be relatively small. On the other hand, although no direct regulation of wages is attempted, the consumption out of wages is somewhat restricted by rationing, which—though it is not very effective for preventing inflation—will probably result in a considerable increase in working-class savings, which will be borrowed by the government, either directly or indirectly.

This type of policy may be admirable on social grounds, but it does complicate the budgetary problem of the debt. We are likely to be left at the end of this war, with an additional War Debt, which is principally either Compensatory or External, or else is in the hands of classes of persons who do not pay direct taxation at high rates. The war profiteer who is so convenient to the Exchequer, because he can be made to pay back so much of what is nominally due to him, may be conspicuous by his absence.[1] It

[1] This characteristic of war profits is a considerable reinforcement to the plea which we have made above in favour of some modification in the rigours of

thus appears that both in respect of the form of the debt, and of its distribution, things are going to be rather difficult.

So far we have not made any allowance for inflation—but that does not make so very much difference, excepting that the interest charges on the old war debt, and on that incurred in the early stages of the present war, being fixed in terms of money, would be easier to bear at a high level of prices. In addition to this, there would be a nominal gain in that progressive taxes would bring a more than proportionately higher yield if the level of money incomes were higher. The Chancellor would thus be able to impose heavier taxation without the disagreeable necessity of increasing the rates. But of course this would not prevent the actual burden of taxation being higher. A more substantial source of relief lies in the fact that owing to the low rate of interest at which it is being accumulated, pound for pound the burden of the new debt will only be about two-thirds of that of the old. But these mitigating factors do not alter the conclusion that the debt burden after the present war is likely to be very serious.

Since the burden is likely to be so heavy, it would be very convenient if we could reduce the volume of the debt by repaying some of it. Unfortunately the prospects of reducing the burden in this way are not very bright. It will probably be agreed that it would be impossible to reduce the debt to any useful extent by a sinking fund, excepting perhaps after three or four generations; during all that time the burden of the debt would be increased, not diminished, by the sinking fund. It is true that the State ought to take long views, but it is not reasonable for it to take such long views as that. The policy of doing without any deliberate sinking fund (apart from what arises from budget surpluses), inaugurated in 1931 with respect to the old debt, is fairly certain to be maintained in respect to the new. It is just as well that it should be so.[1]

The prospects of a levy on war wealth are not much brighter. Owing to the higher rates of E.P.T. and of other direct taxation the new war wealth is likely to be found mainly in the moderate-sized properties. The taxable war wealth in the sense of the increment of wealth in the hands of surtax payers will be relatively

E.P.T. The ultimate cost to the Exchequer of such a concession, even apart from favourable effects on productivity, would be very small.

[1] The same argument applies to any attempt to repay the debt out of a recurrent capital tax, which has most of the evils of a high sinking fund with additional administrative complications. See above, ch. xxii.

smaller than it was last time. There is nothing to suggest that the total increment will be larger, it is quite likely to be smaller. Even with a parallel degree of inflation a war-wealth levy would be less worth while, at least if it was imposed in isolation and not combined with other measures.

Our calculations in the last chapter have established that the net saving from a capital levy of the type discussed by the Colwyn Committee would be too small to be worth the trouble and expense of valuation and collection. The maximum net saving would be very unlikely to exceed the equivalent of 4*d.* or 5*d.* on the income tax, a sum which could be much more easily raised from additional taxation than by the cumbersome machinery of a levy.

One reason for the decline in the net saving of a levy since the time of the Colwyn calculations is the fall in the rate of interest, debt holdings in the aggregate thus giving rise to less taxable capacity. This position could not be altered by any change in the type of levy imposed. But the other reason lies in the extent to which a progressive levy is merely an anticipation of ordinary taxation—particularly of surtax and death duties. If instead of imposing a levy with a progression similar to that of the ordinary tax structure, a levy more nearly proportional to wealth was chosen, the net saving would be substantially increased. For a fully proportional levy it might be two or three times as much as it would be for the progressive levy on which our calculations were based.[1] If in this case the net saving were fully applied to the reduction of income tax it might well provide a definite stimulus to enterprise. Naturally a proportional levy would not have such a strong social justification as a progressive one. But against this it should be borne in mind that it will in any case be combined with a very progressive tax structure. We have seen that in many respects the practicability of a levy has substantially increased since the time of the Colwyn discussions. This is true as much for a proportional as for a progressive levy. Indeed, economically, a proportional levy would probably be distinctly less disturbing. The main difficulties would be administrative. The trouble and delay which would arise in first valuing and then collecting the quotas from a

[1] That is to say the net saving might be about the same as was assumed in the Colwyn discussions (see above, p. 283). It would not be likely to be much more.

large number of small properties would be much greater than for a highly progressive levy.

If the idea of a proportional levy is not acceptable, the community must look forward to paying interest on the war debt which we are now incurring, and to continue paying that interest for an indefinite future. It will clearly be necessary to take all possible steps to minimize its effects.

Before we begin to examine possible ways of relieving the burden it will be useful to look at the problem from a rather long run point of view. Immediately after the war, before the capital lost in the war has been replaced, the burden will be at its maximum. We must face the prospect that at first the interest charge may be too heavy to be covered out of the taxation of the wealthy alone, by any feasible means. For the first five or six years, until the national income has recovered, it may be necessary to continue part of the war taxation on middle and working class incomes. But if, as seems reasonable, we can assume a return to a rate of economic progress at least equal to that which we have enjoyed during the last fifteen years, then after a short period we may hope to reach a position in which the debt burden[1] can be borne with comparative ease out of the expanded national income. It is for the first difficult years after the war that measures to minimize the debt burden are especially needed.

The most serious economic effect of the high taxation which will have to be imposed in the early post-war years is likely to arise from the restrictive effect on enterprise of a high standard rate of income tax. We have seen[2] that the Colwyn Committee seriously underestimated the evils of a high income tax, because they had regard mainly to its effect on effort, and neglected the manner in which the calculation of the expected yield of a new investment has to be written down to allow for taxation. A great deal of the restrictive effect of income tax on enterprise is due to the manner in which the British tax is levied. When it is desired to increase the personal contribution throughout the income scale the natural method is to raise the standard rate. This automatically has the effect of increasing the tax on undistributed profits as well, which may not be in any way desired.

[1] It would be beyond our field to explore the possibilities of such a reorganization of our banking institutions as might permit of a still further lowering of interest rates after some time, and hence give opportunity for a new conversion operation.

[2] Cf. above, p. 192.

Many suggestions have been made for eliminating the disadvantages of this method of assessment. Some people[1] are in favour of abolishing the standard rate principle altogether, regarding it as an anachronism dating from the time when income tax was proportional. But the device has two very real advantages which it would be a pity to sacrifice. It enormously accelerates the collection of revenue from income tax, and it completely eliminates double taxation of profits of the kind which figures so frequently in foreign taxes on corporate profits. It does not appear that the abolition of the standard rate is necessary for the relief of enterprise. A substantial rebate on undistributed profits would meet the case just as well,[2] without tampering with the advantages of the British system, and would be very much simpler for the Administration.

The relief to company income tax would not provide any additional tax revenue. In the short run it would even cause a loss. In any case the need for new revenue will be very pressing. Now, while we have seen that a recurrent capital tax would be very little help in redeeming the debt, the arguments for a capital tax as a new source of current revenue need to be considered very carefully. The social arguments in its favour are clearly very strong. The losses and hardships of war will have made the protection which the possession of capital gives more conspicuous than ever.[3] A progressive capital tax would have the further advantage that it could very simply be combined with an increment tax on war wealth if such seemed to be desirable. Whether the taxable increment will be large enough to merit individual attention depends on the policy adopted about E.P.T. on the one hand, and on the degree of inflation on the other—matters which cannot be estimated at present. But if the taxable increment does call for action, here is the method of taking it—easier to time than an increment levy, more suitable as a post-war measure than an excess income tax.[4]

Economic arguments are also in favour of a capital tax. Used as current revenue it would have a very different effect from the same tax used for debt redemption. In so far as it was paid out of capital and not out of income it might have a positively useful effect in offsetting any tendency to excessive saving during the post-war

[1] Cf. *Economist, passim*, especially January 13, 1940.

[2] This suggestion is of course no novelty. It was mentioned in the Colwyn discussions.

[3] Cf. above, p. 189.

[4] Cf. above, p. 68.

recession. As we have seen,[1] it would have a much less restrictive effect on enterprise than an equivalent income tax.

With the exception of local rates, recurrent capital taxes have hitherto been avoided in the British tax system, and rightly: they are not nice taxes. Capital taxes are administratively awkward and they very easily become seriously inequitable. The valuation for an acceptable general capital tax would be almost as formidable as for a levy, save that it would not have to be carried through in frenzied haste.

Nevertheless it has several advantages over a levy. It is easier to collect, economically it is very much less disturbing, and no problem of timing arises. But it has one very grave drawback. If serious injustice is to be prevented it is absolutely essential to carry out periodical revaluations at regular and fairly frequent intervals. The dangers of neglecting to do so need no emphasis to anyone familiar with the impasse into which the local rating system has drifted. By the time general periodical revaluations were made compulsory it was too late to enforce them. But the very chaos into which the rating system has drifted provides an argument in favour of the capital tax. In a general valuation the disorders of rating could more easily and more equitably be straightened out. Although the revaluation of property at intervals of three or five years would be a considerable undertaking,[2] the subsequent valuations, where it was only a question of measuring changes, should be distinctly less formidable than the initial assessment. Nor need it be assumed that the capital tax must necessarily last for ever. Its main purpose is to lighten the burden of the debt during the years when it is heaviest.

Admittedly these measures would not remove the debt burden, they would only make it economically easier to bear. Under the most favourable circumstances, including the successful choice of an exchange parity which allows the national income to expand without unduly increasing the burden of our external obligations, the internal debt burden will inevitably be heavy. There is no cure for the destruction of capital, either by inflation or by any other method. It is often argued that the way to keep down the burden

[1] Cf. above, ch. xxii.

[2] Especially in respect of the private company which, it must be admitted, does present a most formidable obstacle to the successful administration of an equitable capital tax.

of the debt is by raising tax rates during the war. This is true, but it is only part of the truth. There are some sorts of taxation which hamper the war effort by leading to waste. A better way of reducing the burden of the war debt is often to be found by watching the expenditure side. The elaborate peace-time checks on expenditure are neither possible nor desirable during the hurry and confusion of war. What is wanted is a system which makes the best use of the spontaneous self-sacrifice and hard work which will be freely given in war-time. The modifications in E.P.T. which we have suggested are designed just for this purpose. A wise policy in the taxation of war wealth will lighten the problems of peace as well as those of war.

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